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CIS

CREDIT CARD INTEREST RATES

HEARING

BEFORE THE

SUBCOMMITTEE ON
CONSUMER AFFAIRS AND COINAGE

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

ON

H.R. 1197

A BILL TO AMEND THE TRUTH IN LENDING ACT TO LIMIT THE RATE OF INTEREST WHICH MAY BE CHARGED ON CREDIT CARD ACCOUNTS

H.R. 3408

A BILL TO AMEND THE TRUTH IN LENDING ACT TO ESTABLISH A LIMITATION ON THE RATES OF INTEREST WHICH MAY BE IMPOSED ON CREDIT CARD ACCOUNTS, TO PROVIDE THAT SUCH LIMITATION SHALL TAKE EFFECT ON OCTOBER 1, 1986, UNLESS THE DETERMINATION IS MADE THAT SUCH RATES REFLECT THE COST OF FUNDS TO CREDITORS AND COMPETITION AMONG CREDITORS FOR NEW CREDIT CARD ACCOUNTS, AND FOR OTHER PURPOSES

OCTOBER 29, 1985

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CREDIT CARD INTEREST RATES

TUESDAY, OCTOBER 29, 1985

House of Representatives,
Subcommittee on Consumer Affairs and Coinage,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Frank Annunzio (chairman of the subcommittee) presiding.

Present: Chairman Annunzio; Representatives Gonzalez, Barnard, Hiler, Wylie, Ridge, and Roth.

Chairman **Annunzio**. The subcommittee will come to order. Those standing in the aisles, please find a seat.

Whoever wrote the words, "What goes up must come down," never heard of credit card interest rates. Yes, credit card interest rates have gone up, way up, but with few exceptions, financial institutions have not lowered the rates they charge on credit card interest, even though the cost of funds to these institutions have dropped dramatically.

There have been many stories in the media about how credit card interest rates have skyrocketed, but the situation is made even worse in that rates paid to savers have dived as rapidly as credit card rates have risen. This doubles the magnitude of the problem.

This morning, the subcommittee holds hearings on the general question of credit card interest rates, and on two bills that would set ceilings on these rates.

There is no question that something needs to be done. It is my firm belief that consumers are being charged far too much for the use of credit cards. The national average for credit card interest rates is 18.62 percent. The prime rate has fallen to 9.5 percent, and the discount rate, the rate charged by the Federal Reserve to bank borrowers, is down to 7.5 percent.

It must be remembered that credit card interest rates shot up when the prime rate was close to 20 percent, and savers were earning up to 17 percent on their money market accounts. Financial institutions argued at that time that the higher rates were necessary because their costs of funds were so high. Many State legislatures raised the interest rate ceilings so that credit card issuers could charge the higher rate due to the emergency nature of the situation.

Let me also point out that about that same time, credit card issuers began charging annual fees for their cards. When I opposed such fees, the credit card companies argued that by charging fees for all cardholders, they would be able to keep the interest charges down for those 70 percent of their customers who could not pay off their balances in full every month.

And just before annual fees were instituted, the credit card issuers changed from so-called country club billing to descriptive billing. That is, that instead of sending all sales slips back to the consumer, the financial institution sent a summary of the transactions. I opposed this switch, but the credit carders argued that the switch in billing would save millions of dollars, and this savings would mean that interest rates on the cards could be kept down.

And let's not forget that about the same time that all this was going on, most financial institutions switched their method of computing credit card interest costs to a newly devised system that, in effect, doubled the interest rate without violating any State rate ceiling. This bookkeeping sleight-of-hand cost consumers billions of dollars a year, and they received no benefits from these increased costs.

I fought against the new billing techniques, but once again, the financial institutions argued that it would keep overall interest costs low.

If all of these actions were designed to lower interest rates for consumers, I would hate to see what would happen if financial institutions were trying to increase rates.

It is time that credit card issuers live up to their promises that all of their new methods of operation would lower rates. Some financial institutions around the country have lowered their credit card rates, and I commend them. Two weeks ago, Manufacturers Hanover Trust in New York dropped its rate 2 percentage points. I am proud that the credit union which serves the House of Representatives, the Wright Patman Congressional Federal Credit Union, has reduced its credit card rate to 16.8 percent, and has never charged an annual fee for its card.

When Manufacturers Hanover cut its rate, I stated that if indeed credit card rates were a product of the marketplace, then other financial institutions would follow the actions of the New York bank. There is no doubt in my mind that when interest rates go up, the marketplace follows along, and banks cannot increase rates fast enough. But apparently the marketplace shorts out when rates are dropping and it is the consumers who benefit. Not only have other financial institutions not followed the lead of Manufacturers Hanover, but officials of that financial institution refused to come before the subcommittee to testify about their credit card rate cuts.

I strongly support legislation to reduce credit card interest rate charges. In my 21 years in the House I have not only fought for interest rate ceilings, but I have fought against every attempt to remove the ceilings on other loan programs or to override State-imposed ceilings.

I am committed to going forth with rate cutting legislation, but I am a political realist. I do not want consumers to get their hopes up that rate cutting legislation is going to breeze through the Congress. Unfortunately, Congress has not looked kindly on rate cutting legislation, and historically it has gone the other way—by lifting rate ceilings.

But that does not mean that the battle is lost. I am hopeful that today's hearing will focus enough attention on this problem so that consumers will take matters into their own hands. There are more than 700 million credit cards in circulation in this country. And these are in the hands of some 91 million Americans, who are paying $6 billion in interest charges.

We will be told today by opponents of a rate cut that since consumers continue to use their credit cards so freely, there is no reason to cut the interest rate. This is called whatever the traffic will bear logic.

In short, as long as consumers are willing to use their credit cards and pay the record rates, the rates will not only stay high, but I predict will go even higher. And it will not be too long before additional costs are added such as a fee every time the credit card is used.

If consumers are willing to put up with the high costs, then they should continue to use their cards at the current pace. But if consumers feel that there is no legitimate basis for the high rates, then they can solve the problem themselves, and they can do it far quicker than Congress can pass legislation. If consumers stop using their credit cards or at the very least use them only for emergency purposes, credit card rates would fall overnight. The first time that credit card companies would see a drop in credit card usage, consumers would see a corresponding drop in interest rates.

So what I am proposing is that the Nation's 91 million credit cardholders put their plastic in their pockets and leave them there until interest rates drop. It will not take very long for the message to get across. If enough consumers take their credit cards out of circulation, or better yet, if they cut them up and mail them back to the issuer, not only will rates go down, but you will see credit card issuers vying to see who can cut their rates to the lowest and to attract the disenchanted credit card users. All it will take is a few front page stories in some of our Nation's bigger papers or a television clip showing a credit card burning party, and the wheels will start to turn in the board rooms of the Nation's financial community.

I have had some experience as chairman of this subcommittee with boycotts of consumer goods. I can recall not too long ago when beef prices became astronomical, and I urged from this podium, a boycott of beef at the supermarket. And I tell you, that boycott on the part of the customers worked. The beef prices came down and stayed down.

You know, many years ago, I also made a statement that we had become a nation of credit card junkies. We are addicted to the plastic card. Just as those addicted to alcohol, narcotics and so forth, in order to get cured of alcoholism or narcotics addiction, you have to do it by yourself, you have to get some help. We are addicted to plastic cards, and the sooner we look in the mirror, the sooner we hold that card up and see our face in the mirror and say "I am addicted to plastic cards, and I am going to get rid of this damn thing," the better off you are going to all be.

Mr. Hiler. Let's cut them up now.

Chairman Annunzio. Mr. Hiler, the ranking Republican Member, says we are going to take our plastic cards and cut them up. To be honest with you, that is what I was going to do this morning, but I changed my mind. I had a good reason for doing that, you know, I personally don't have a credit card, so I can't cut up something I don't have. My wife doesn't have a credit card. The only people in my family that have credit cards—I am no different than any other man that has been married 49 years—my daughters have the credit cards.

Mr. Hiler.

Mr. Hiler. I thank the chairman for yielding, and I find many things in the chairman's statement that I agree with, and a few things that I disagree with. But I certainly agree with the substance of the last several paragraphs of his remarks, and that is that credit cards are not a public utility. We don't need lifeline credit cards like we have lifeline electricity rates or lifeline phones. I am not even sure credit cards would fit into the concept of what people would consider lifeline banking.

As the chairman said, if the price gets too high, the consumer stops using the product, and at that point, the price will go down or the product will no longer be marketed.

I think it is important as we study this issue and have these hearings today to appreciate the fact that credit cards are not a fundamental right of all Americans that must be guaranteed for all citizens, that is embodied in our Constitution. Unfortunately, neither the Congress nor regulators in our States have been particularly successful at imposing rate ceilings on interest rates and having it flow through the marketplace without a great deal of disruption, many times robbing consumers of the ability to get a product to begin with.

I think that the chairman is right on the mark when he says that if the price is too high, if the price is a price that is one that is bringing profits that are excessive to the issuers of credit cards, one of two things will happen. Consumers will stop using credit cards, and there will be a service that is not used, or others will come into the business and begin to bring rates down. I think the market, while it may not be a perfect market as described in our textbooks, the market for financial services is a fairly real market, it is one that there is a tremendous amount of competition. The fact there are some 750 million credit cards in the system says something about the fact there is a degree of competitiveness and degree of pervasiveness in the marketplace.

So I think as we look for solutions to try to bring interest rates down, I think that rather than the Congress imposing artificial restraints, our time might be better spent if we concentrated on lowering the deficit and removing impediments to the market forces rather than increasing the impediments.

I yield back to the chairman.

[The texts of H.R. 1197, H.R. 3408 and a side-by-side summary of the legislation follow:]

99TH CONGRESS
1ST SESSION

H. R. 1197

To amend the Truth in Lending Act to limit the rate of interest which may be charged on credit card accounts.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 21, 1985

Mr. BIAGGI introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

---

A BILL

To amend the Truth in Lending Act to limit the rate of interest which may be charged on credit card accounts.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 106 of the Truth in Lending Act (15 U.S.C. 1605) is amended by adding at the end thereof the following new subsection:

"(f) The rate of interest charged on any consumer credit transaction involving a credit card shall not be more than 5 percentage points higher than the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district in which the card issuer is located.".

99TH CONGRESS
1ST SESSION

H. R. 3408

To amend the Truth in Lending Act to establish a limitation on the rates of interest which may be imposed on credit card accounts, to provide that such limitation shall take effect on October 1, 1986, unless the determination is made that such rates reflect the cost of funds to creditors and competition among creditors for new credit card accounts, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

SEPTEMBER 20, 1985

Mr. SCHUMER introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

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A BILL

To amend the Truth in Lending Act to establish a limitation on the rates of interest which may be imposed on credit card accounts, to provide that such limitation shall take effect on October 1, 1986, unless the determination is made that such rates reflect the cost of funds to creditors and competition among creditors for new credit card accounts, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Credit Card Interest Rate Limitation Act of 1985".

SEC. 2. LIMITATION IMPOSED ON RATES OF INTEREST WHICH MAY BE IMPOSED ON CREDIT CARD ACCOUNTS.

(a) In General.—Chapter 2 of the Truth in Lending Act (15 U.S.C. 1631 et seq.) is amended by adding at the end thereof the following new section:

"SEC. 137. MAXIMUM RATES OF INTEREST ON CREDIT CARD ACCOUNTS.

"(a) In General.—The rate used to compute the finance charge imposed for any period on any credit extended through the use of a credit card shall not exceed—

"(1) the maximum annual percentage rate for the calendar quarter during which such period begins, divided by

"(2) the number of such periods which begin during the calendar year in which such calendar quarter occurs.

"(b) Maximum percentage rate.—

"(1) Definition.—The maximum annual percentage rate applicable under subsection (a) for each calendar quarter is the sum of 6 percent and the average annual percentage yield on 3-month obligations of the United States issued by the Secretary of the Treasury under section 3104(a) of title 31, United States Code, during the second calendar month of the calendar quarter preceding such calendar quarter.

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"(2) DETERMINATION BY SECRETARY.—Before the 5th day of the third month of each calendar quarter. the Secretary of the Treasury shall—

"(A) determine the average annual percentage yield on 3-month obligations of the United States issued by such Secretary during the calendar month preceding such third month, and

"(B) notify the Board of such determination.

"(3) DETERMINATION AND PUBLICATION BY BOARD.—Upon receiving notice of an average annual percentage yield determination from the Secretary of the Treasury under paragraph (2) during the third month of any calendar quarter, the Board shall determine the maximum annual percentage rate for the next succeeding calendar quarter and shall publish notice of such determination in such manner as the Board shall prescribe.".

(b) STUDY AND REPORT BY BOARD.—

(1) STUDY REQUIRED.—The Board of Governors of the Federal Reserve System shall conduct a study of—

(A) the relationship between—

(i) interest rates on credit extended through the use of credit cards during the period beginning on January 1, 1979, and ending on December 31, 1985, and

(ii) the cost of funds to banks and other creditors for the extension of such credit during such period; and

(B) the degree to which interest rates on such credit reflected competition among creditors for new credit card accounts during such period.

(2) REPORT REQUIRED.—On or before June 1, 1986, the Board shall submit a report of such study to the Chairman of the Committee on Banking, Finance, and Urban Affairs of the House of Representatives and the Chairman of the Committee on Banking, Housing, and Urban Affairs of the Senate.

(3) DEFINITIONS.—For purposes of this subsection, the terms "credit", "creditor", and "credit card" each have the meanings given to such terms by section 103 of the Truth in Lending Act (15 U.S.C. 1602).

(c) COORDINATION WITH OTHER LAWS.—Subsection (b) of section 111 of the Truth in Lending Act (15 U.S.C. 1610) is amended—

(1) in subsection (b) by striking out "This title" and inserting in lieu thereof "Except as provided in subsection (e), this title";

(2) in subsection (d) by striking out "and 166" and inserting in lieu thereof "137, and 166"; and

(3) by adding at the end thereof the following new subsection:

"(e) Maximum Credit Card Rate Provisions.—

"(1) Federal maximum supersedes higher state maximum.—To the extent the law of any State permits the use of a rate in excess of the rate determined under section 137 to compute any finance charge which is subject to such section, the provisions of such section shall supersede the law of such State.

"(2) Publication by board satisfies certain notice requirements.—

"(A) In general.—If the maximum annual percentage rate determined by the Board under section 137(b)(3) for any calendar quarter exceeds the maximum annual percentage rate in effect for the calendar quarter preceding such calendar quarter, the publication of such determination by the Board under such section shall be deemed to satisfy the provisions of any State notification law applicable to any rate which is subject to section 137 so as to allow an increase by the creditor in such rate for any period beginning in such quarter, subject to any other law of such State which is not inconsistent with any provision of this title.

"(B) STATE NOTIFICATION LAW DEFINED.—For purposes of subparagraph (A), the term 'State notification law' means—

"(i) any law of a State which requires a creditor to provide notice to any person to whom credit has been extended before the creditor may increase the rate used to compute the finance charge imposed on such credit, and

"(ii) any provision of the law of a State relating to the time and method for providing any notice described in clause (i).".

(d) CLERICAL AMENDMENT.—The table of sections for chapter 2 of such Act is amended by adding at the end thereof the following new item:

"137. Maximum rates of interest on credit card accounts.".

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—Subject to paragraph (2), the amendments made by subsections (a), (c), and (d) shall apply to credit extended during calendar quarters beginning after September 30, 1986.

(2) LIMITATION NOT TO TAKE EFFECT IF CREDIT RATES ARE COMPETITIVE WITH COST OF FUNDS.—If, after conducting the study required under

subsection (b), the Board of Governors of the Federal Reserve System determines that, during the period studied, interest rates imposed on credit extended through the use of credit cards reflected the cost of funds to creditors for the extension of such credit and competition among creditors for new credit card accounts, the amendments made by subsections (a), (c), and (d) shall not take effect.

SIDE-BY-SIDE SUMMARY OF PENDING CREDIT CARD INTEREST RATE LEGISLATION

H.R. 1197 (Mr. Biaggi)
Introduced 2/21/85

Sets a maximum interest rate on any credit card transaction of not more than five percentage points higher than the discount rate on 90-day commercial paper in effect in the Federal Reserve district in which the card issuer is located.

H.R. 3408 (Mr. Schumer)
Introduced 9/20/85

1) Sets a maximum interest rate for credit cards of 6 percent plus the average annual percentage yield of three-month Treasury bills during the 2nd calendar month of the preceding quarter.

2) Requires the Federal Reserve to conduct a study on credit card interest rates between 1979-1985 and the cost of funds to creditors during the same period.

3) Provides that Federal law supersedes any State law.

4) Interest rates would not go into effect until calendar quarter beginning after 9/30/86.

Legislation would not go into effect if Fed determines that interest rates reflect the cost of funds to creditors.

Chairman **Annunzio**. Ms. Seger, will you take your place with the panel.

Are there any other members of the panel who would like to say something this morning?

Mr. **Roth**. In the interest of time, I would like to ask my statement be included in the record.

Chairman **Annunzio**. Without objection.

[The opening statement of Hon. Toby Roth follows:]

OPENING STATEMENT OF

REP. TOBY ROTH

HEARING ON CREDIT CARD INTEREST RATES

I commend you, Mr. Chairman, for holding these hearings today. This truly meets the definition of a "pocketbook issue".

The credit card industry today is one of the nation's largest. Half the people in this country possess at least one credit card, and most people have more. The interest rates charged by financial services companies have a direct impact on the finances of most American families.

I think what all of us want to do is prevent abuse, or what amounts, in some minds, to usury.

The question, of course, is how to achieve this goal without serious disruption in the marketplace and without denying deserving consumers access to credit.

The bills which are the subject of these hearings would in one way or another place arbitrary ceilings on credit card interest rates. while I am sympathetic to the motives behind this legislation, I am concerned about the potential effects of such legislation. I am not convinced these approaches represent the best way to deal with the problem.

We have a broad and burgeoning credit card market today. Everyone's mail contains solicitations for VISA or Master Cards. These solicitations come because there is a demand for consumer credit. More important, they represent an apparent willingness on the part of consumers to accept the obligations they entail.

At the same time, I agree that credit card interest rates are higher than they need to be to ensure a fair profit to their issuers. I hope these hearings will answer my questions as to how we can effectively cut those rates. I would like to think we can, through improved disclosure or voluntary good faith efforts, deal with the problem.

Our last recourse should be interest rate ceilings. History should tell us that dealing with essentially free marketed in such an arbitrary manner can have unintended consequences.

I welcome my colleagues Reps. Schumer and Biaggi, Governor Seeger, and the other distinguished witnesses. I look forward to their comments and their suggestions.

Chairman ANNUNZIO. Are there any other statements to be included in the record? All statements will be made part of the record, without objection.

This morning I welcome the distinguished panel. At this time I would like to welcome my colleague, Charles Schumer of Brooklyn, NY, before the subcommittee. Upon graduation from Harvard Law School, Mr. Schumer was elected to the New York State Assembly at age 23 where he served for 7 years. Mr. Schumer was elected to Congress in 1980, 3 weeks before his 30th birthday. He has gained a vast amount of political experience at a very young age.

It is my pleasure to serve with Mr. Schumer not only in the House but on the Banking Committee. He has brought expertise to many of the issues addressed by the full committee. It is my pleasure to have him testify before the subcommittee today.

Before you testify, Mr. Schumer, all witnesses have been told that they can submit a statement of any length for the record. Their oral presentation this morning will be limited to 10 minutes. By holding to this time limit, we will be able to complete the hearings this morning. So, without objection, Mr. Schumer, your entire statement will be made part of the record. You can proceed in your own manner for 10 minutes.

STATEMENT OF HON. CHARLES E. SCHUMER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. SCHUMER. Thank you, Mr. Chairman.

It is my honor to be here today. Before I begin my testimony, I would like to salute you and the subcommittee for holding these hearings. It is no secret that the cause of consumers in financial industries has been advanced probably more by you than any other Member of Congress. I think consumers throughout the country are grateful for your leadership on not only this issue but all consumer issues.

It is my honor to be here before you and members of this distinguished subcommittee. Consumers are bombarded daily with credit card commercials that tell them these credit cards will make you so worldly, so welcome. As consumers have become so welcome, lenders have become so wealthy.

There are over 700 million credit cards in circulation in the United States today. Almost one of every two Americans has at least one credit card. If credit card holders are paying excessively high interest charges, this is a problem that is not restricted to a handful of citizens but affects a vast majority of American households.

In 1981, consumers paid annual interest rates between 17 and 20 percent on automobile and personal loans. Although high rates were a hardship on consumers, the rates were dictated by the state of the economy and reflected the cost of money. While undesirable, the rates were fair.

In 1985, fortunately, most interest rates have fallen. In August, the average new car loan was below 11 percent; 24-month, unsecured personal loans averaged 16 percent. However, not all rates have fallen. As the chart shows, credit card rates in 1985 have averaged almost 19 percent and have actually increased since the summer of 1981, when the cost of money peaked. Credit cards are high without any apparent relation to the cost of money. This is both undesirable and unfair.

Bank credit card revenues on a debt of $55 billion totaled over $8 billion in 1984. And bank cards represent only about half of credit card debt. Thus, consumers probably paid about $16 billion in interest and fees last year. This means that consumers paid almost $4 billion more than they would have if rates had averaged a reasonable 6 points higher than the 3-month Treasury bill. For $4 billion a year, you are better off leaving home without it.

Banks and other creditors maintain that credit card rates are high for legitimate reasons. I agree that credit card loans cost more to finance than other loans because of small principal amounts, monthly billing, and the open-ended nature of the credit. However, these costs have remained constant from 1980. At the same time, the one major cost of credit cards that is not a fixed cost, the cost of money, has fallen 8 points, more than 50 percent, since 1981, as credit card rates have risen. The banks and other credit card issuers have simply not been able to explain this inconsistency.

When I look at the industry, the explanation I see is that lenders are taking advantage of uninformed and unsophisticated consumers to charge usurious rates. Consumers don't shop around for credit cards. Even if they did until a few weeks ago, there was virtually nowhere they could turn for a lower rate. Many don't know that different banks offer different rates on VISA and MasterCard. Most consumers think all VISA rates and all MasterCard rates are the same. They are not. Some know the rates differ, but think they must get their cards from their own bank. That is also not true. And some are discouraged from switching credit cards in midyear by the cost of paying two annual fees. But most just find that virtually every lender charges the same rate.

My impression that banks are charging unfair rates seemed to be confirmed by the response of some members of the industry to this subcommittee's announcement that it would hold these hearings. A few days following the announcement, a representative of the Manufacturers Hanover Bank, the 10th largest credit card holder, called my office to announce the bank was lowering its rates from 19.8 percent to 17.8 percent.

One reason cited for the rate reduction was the bank's desire to convince Congress the industry can operate competitively. If the industry can operate competitively, why did it take the threat of congressional hearings to force the rate down? And if Manufacturers Hanover, a prudent and profitable institution, can lower its credit card rates and still make money, why haven't other big banks followed suit? Unfortunately, it takes two to compete.

The evidence that the credit card market is not competitive is convincing but not conclusive. All the data necessary to make an accurate determination is simply not available. This data should be developed and reviewed before an interest rate cap is implemented. Therefore, the legislation that I have introduced delays the imposition of a ceiling until after a Federal Reserve Board finding that rates are not competitive or do not reflect the cost of funds to creditors.

Specifically, H.R. 3408 requires the Board of Governors of the Federal Reserve to examine interest rates on credit cards between January 1, 1979, and December 31, 1985. If the Fed determines that the rates reflect the cost of funds to creditors and competition among creditors for new accounts, then no cap will be imposed. However, if either condition is not met, a maximum rate will be imposed.

The rate will be 6 percent over the average rate of 3-month Treasury bills issued during the second month of the preceding quarter. This mechanism will give lenders sufficient warning of the new cap to allow prompt adjustment of the rates they charge consumers.

The aim of H.R. 3408 is to restore competition to the credit card market. I kept this goal in mind in all my decisions on the details of the bill. I chose the 3-month Treasury bill rate rather than the prime rate or discount rate because it is a market rate. I chose a 6-point spread because I hoped lenders would compete by offering rates below the Federal cap.

Also, in an effort to promote competition, the bill preempts State notification requirements if lenders raise their rates in response to an increase in the Federal cap. Currently some States require lenders to give as much as 6 months' notice, and the bill would end that.

When the Congress ushered in the era of deregulation, when we lifted the ceilings that you talked about, Mr. Chairman, deregulation was supposed to increase competition and benefit consumers. If interest rates on credit cards are any indication of how deregulation has helped consumers, then maybe we ought to abandon the whole idea of deregulation. I oppose unnecessary Government intervention in the marketplace, but I am equally opposed to consumers getting bilked into usurious rates on credit cards.

I believe my bill is equitable to both lenders and consumers. If credit card lenders are operating competitively in a free market, no ceiling will be imposed. If rates are being held high artificially, consumers will be protected. My bill gives the market a fair chance, but if the market is not free, it insures that rates are fair.

I thank the chairman.

[The prepared statement of Hon. Charles E. Schumer follows:]

TESTIMONY OF HON. CHARLES E. SCHUMER

I WOULD LIKE TO THANK THE DISTINGUISHED CHAIRMAN AND SUBCOMMITTEE MEMBERS FOR HOLDING THIS TIMELY HEARING AND ALLOWING ME TO TESTIFY.

CONSUMERS ARE BOMBARDED DAILY WITH CREDIT CARD COMMERCIALS THAT TELL THEM THESE CARDS WILL MAKE THEM SO WORDLY, SO WELCOME. WHAT THE COMMERCIALS DON'T POINT OUT IS THAT AS CONSUMERS HAVE BECOME SO WELCOME, CREDIT CARD LENDERS HAVE BECOME SO WEALTHY.

THERE ARE OVER 700 MILLION CREDIT CARDS IN CIRCULATION IN THE UNITED STATES TODAY. ALMOST ONE OF EVERY TWO AMERICANS HAS AT LEAST ONE CREDIT CARD. SO IF CREDIT CARD HOLDERS ARE PAYING EXCESSIVELY HIGH INTEREST CHARGES, THIS IS A PROBLEM THAT IS NOT RESTRICTED TO A HANDFUL OF CITIZENS BUT AFFECTS A VAST MAJORITY OF AMERICAN HOUSEHOLDS.

AMERICANS KNOW THE BURDEN OF HIGH INTEREST RATES. IN 1981, CONSUMERS PAID ANNUAL INTEREST RATES BETWEEN 17 AND 20 PERCENT ON AUTOMOBILE AND PERSONAL LOANS. ALTHOUGH HIGH RATES WERE A HARDSHIP ON CONSUMERS, THE RATES WERE DICTATED BY THE STATE OF THE ECONOMY AND REFLECTED THE COST OF MONEY. WHILE UNDESIRABLE, THE RATES WERE FAIR.

IN 1985, MOST INTEREST RATES FORTUNATELY HAVE FALLEN. IN AUGUST, THE AVERAGE NEW CAR LOAN IN AUGUST WAS BELOW 11% AND

24-MONTH PERSONAL LOANS AVERAGED UNDER 16%. BUT NOT ALL RATES HAVE FALLEN. CREDIT CARDS RATES IN 1985 AVERAGE ALMOST 19% AND HAVE ACTUALLY INCREASED SINCE THE SUMMER OF 1981 WHEN MOST RATES PEAKED. CREDIT CARDS RATES ARE HIGH WITHOUT AN APPARENT RELATION TO THE COST OF MONEY. THIS IS BOTH UNDESIRABLE AND UNFAIR.

BANKCARD REVENUES ON A DEBT OF $55 BILLION TOTALED OVER $8 BILLION IN 1984. AND BANKCARDS ONLY REPRESENT ABOUT HALF OF THE CREDIT CARD DEBT. THUS, CONSUMERS PROBABLY PAID ABOUT $16 BILLION IN INTEREST AND FEES LAST YEAR ALONE. THIS MEANS THAT CONSUMERS PAID ALMOST $4 BILLION MORE THAN THEY WOULD HAVE IF RATES HAD AVERAGED A REASONABLE 6 POINTS OVER 3-MONTH T-BILLS. FOR $4 BILLION DOLLARS A YEAR, YOU'RE BETTER OFF LEAVING HOME WITHOUT IT.

BANKS AND OTHER CREDITORS MAINTAIN THAT CREDIT CARD RATES ARE HIGH FOR LEGITIMATE REASONS. I AGREE THAT CREDIT CARD LOANS COST MORE TO FINANCE THAN OTHER LOANS BECAUSE OF SMALL PRINCIPAL AMOUNTS, MONTHLY BILLING, AND THE OPEN-ENDED NATURE OF THE CREDIT. HOWEVER, THESE HIGHER COSTS REMAIN RELATIVELY CONSTANT, WHILE THE COST OF FUNDS VARIES. THREE-MONTH TREASURY BILLS, PERHAPS THE BEST APPROXIMATION OF THE SHORT-TERM COST OF MONEY, HAVE FALLEN 8 POINTS, MORE THAN 50%, SINCE 1981. CREDIT CARDS RATES HAVE RISEN. THE BANKS HAVE SIMPLY NOT BEEN ABLE TO EXPLAIN THIS INCONSISTENCY TO MY SATISFACTION.

WHEN I LOOK AT THE INDUSTRY, THE EXPLANATION I SEE IS THAT LENDERS ARE TAKING ADVANTAGE OF UNINFORMED AND UNSOPHISTICATED CONSUMERS TO CHARGE USURIOUS RATES. CONSUMERS DON'T SHOP AROUND FOR CREDIT CARDS. SOME DO NOT KNOW THAT DIFFERENT BANKS OFFER DIFFERENT RATES ON VISA AND MASTERCARD. SOME KNOW THAT RATES DIFFER BUT THINK THEY MUST GET THEIR CARD FROM THEIR OWN BANK. SOME ARE DISCOURAGED FROM SWITCHING CARDS IN MID-YEAR BY THE COST OF PAYING TWO ANNUAL FEES. BUT MOST JUST FIND THAT VIRTUALLY EVERY LENDER CHARGES THE SAME RATE.

MY IMPRESSION THAT BANKS ARE CHARGING UNFAIR RATES SEEMED TO BE CONFIRMED BY THE RESPONSE OF SOME MEMBERS OF THE INDUSTRY TO THE SUBCOMMITTEE'S ANNOUNCEMENT THAT IT WOULD HOLD THESE HEARINGS. A FEW DAYS FOLLOWING THE ANNOUNCEMENT, A REPRESENTATIVE OF MANUFACTURER'S HANOVER BANK, THE 10TH LARGEST CREDIT CARD DEBT HOLDER, CALLED MY OFFICE TO ANNOUNCE THAT THE BANK WAS LOWERING ITS RATES FROM 19.8% TO 17.8%. ONE REASON CITED FOR THE RATE REDUCTION WAS THE BANK'S DESIRE TO CONVINCE CONGRESS THAT THE INDUSTRY CAN OPERATE COMPETITIVELY. IF THE INDUSTRY CAN OPERATE COMPETITIVELY, WHY DID IT TAKE THE THREAT OF CONGRESSIONAL ACTION TO FORCE RATES DOWN? AND, IF MANUFACTURER'S HANOVER, A PRUDENT AND PROFITABLE INSTITUTION, CAN LOWER ITS CREDIT CARD RATES AND STILL MAKE MONEY, WHY HAVEN'T OTHER BIG BANKS FOLLOWED SUIT? UNFORTUNATELY, IT TAKES TWO TO COMPETE.

THE EVIDENCE THAT THE CREDIT CARD MARKET IS NOT COMPETITIVE

IS CONVINCING BUT NOT CONCLUSIVE. ALL THE DATA NECESSARY TO MAKE AN ACCURATE DETERMINATION IS SIMPLY NOT AVAILABLE. THIS DATA SHOULD BE DEVELOPED AND REVIEWED BEFORE AN INTEREST RATE CAP IS IMPLEMENTED. THEREFORE, THE LEGISLATION THAT I HAVE INTRODUCED DELAYS THE IMPOSITION OF A FEDERAL CEILING UNTIL AFTER A FEDERAL RESERVE BOARD FINDING THAT RATES ARE NOT COMPETITIVE OR DO NOT REFLECT THE COST OF FUNDS TO CREDITORS.

SPECIFICALLY, H.R. 3408 REQUIRES THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE TO EXAMINE THE INTEREST RATES ON CREDIT CARDS BETWEEN JANUARY 1, 1979, AND DECEMBER 31, 1985. IF THE FED DETERMINES THAT THE RATES REFLECT THE COST OF FUNDS TO CREDITORS AND COMPETITION AMONG CREDITORS FOR NEW ACCOUNTS, THEN NO CAP WILL BE IMPOSED. HOWEVER, IF EITHER CONDITION IS NOT MET, A MAXIMUM ANNUAL RATE WILL BE IMPOSED.

THE RATE, ADJUSTED QUARTERLY, WILL BE SET AT 6 POINTS OVER THE AVERAGE RATE ON 3-MONTH TREASURY BILLS ISSUED DURING THE SECOND MONTH OF THE PRECEDING QUARTER. THIS MECHANISM WILL GIVE LENDERS SUFFICIENT WARNING OF THE NEW CAP TO ALLOW PROMPT ADJUSTMENT OF THE RATES THEY CHARGE CONSUMERS.

THE AIM OF H.R. 3408 IS TO RESTORE COMPETITION TO THE CREDIT CARD MARKET. I KEPT THIS GOAL IN MIND IN ALL MY DECISIONS ON THE DETAILS OF THE BILL. I CHOSE THE 3-MONTH TREASURY BILL RATE RATHER THAN THE PRIME RATE OR THE DISCOUNT RATE BECAUSE IT WAS A

MARKET RATE. I CHOSE A 6 POINT SPREAD, BECAUSE I HOPE THAT LENDERS WOULD COMPETE BY OFFERING RATES BELOW THE FEDERAL CAP.

ALSO IN AN EFFORT TO PROMOTE COMPETITION, THE BILL PREEMPTS STATE NOTIFICATION REQUIREMENTS IF LENDERS RAISE THEIR RATES IN RESPONSE TO AN INCREASE IN THE FEDERAL CAP. CURRENTLY SOME STATES REQUIRE LENDERS TO GIVE AS MUCH AS 6 MONTHS NOTICE TO CONSUMERS BEFORE THE EFFECTIVE DATE OF AN INTEREST RATE INCREASE. IN THE PAST, THESE REQUIREMENTS HAVE DISCOURAGED CREDITORS FROM LOWERING RATES FOR FEAR THAT THEY WOULD NOT BE ABLE TO RAISE THEM QUICKLY ENOUGH WHEN THE COST OF FUNDS ROSE. MY BILL ENSURES THAT THE RATES CONSUMERS PAY WILL RESPOND QUICKLY TO THE CHANGING COST OF FUNDS.

I OPPOSE UNNECESSARY GOVERNMENT INTERVENTION IN THE MARKET PLACE, BUT I AM EQUALLY OPPOSED TO CONSUMERS GETTING BILKED INTO PAYING USURIOUS RATES ON CREDIT CARD LOANS. I BELIEVE THAT MY BILL IS EQUITABLE TO BOTH CREDIT CARD LENDERS AND CONSUMERS. IF CREDIT CARD LENDERS ARE OPERATING FAIRLY IN A COMPETITIVE MARKET, NO CEILING WILL BE IMPOSED. HOWEVER, IF RATES ARE BEING HELD HIGH ARTIFICIALLY, CONSUMERS WILL BE PROTECTED. MY BILL GIVES THE FREE MARKET A FAIR CHANCE, BUT IF THE MARKET IS NOT FREE, IT ENSURES THAT RATES ARE FAIR.

Chairman ANNUNZIO. I thank my distinguished colleague for his very effective statement.

I also would like to remind him that in 1980 I was a member of the conference committee on deregulation, and I was the only member of the conference who did not sign that report. I said at that time that deregulation would play havoc with the consumers of this country. We see it not only in finance charges, but we are finding out that our telephone bills are much higher, our utility bills are going higher, and that is what deregulation has brought to America. It has brought a bonanza to people that are skimming, you know, the top for profits, and there isn't enough to go around.

So when we talk about deregulation and reregulation, it is very difficult, Mr. Schumer, to turn the clock back. It is very difficult. That is one of the things that is wrong with the Gramm-Rudman Act, you know. There is a new Congress elected in the House of Representatives every 2 years. What one Congress does is not binding on another Congress, so if something should go wrong, that Congress would at least have the opportunity to make the adjustment.

Now, this morning I want to welcome a dear colleague and old friend, Mario Biaggi, to the subcommittee. Before coming to Congress, Mr. Biaggi enforced the laws passed by the Congress as a New York City policeman. In his 23 years as one of New York City's finest, he was wounded 10 times in the line of duty. He received 28 heroism commendations, making him the most decorated police officer in New York City's history upon his retirement.

He has always been over the years on the side of law and order and fairness, and thus his introduction of the legislation before us today. I welcome you to our subcommittee and look forward to your testimony.

STATEMENT OF HON. MARIO BIAGGI, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. BIAGGI. Thank you very much, Mr. Chairman.

It is an honor to come before your subcommittee today and discuss what I know is an issue of mutual interest, namely, the exorbitant interest rates consumers are being forced to pay on their credit card interest accounts. Your longstanding concern for the American consumer is well documented, and this hearing today is totally consistent with that record.

I would like to make an observation in relation to what the chairman stated. You stated, Mr. Chairman, that the credit card holders have become addicts. I couldn't agree with you more. So, that being the fact, you are talking about the banking industry and those that issue credit cards as being exploiters of addicts; in a sense it is like a drug addict being exploited by the drug pusher on the street.

Of course, it is a loftier level in our society, but it is the same basic wrong that is being committed. It is exploitation of people who are unmindful of the danger they are subjecting themselves to. The parallel in my mind is foursquare.

The case in support of a national cap on credit card interest rates is easily made. Since 1981, the interest on home mortgages has dropped; interest on auto loans has dropped; interest on individual savings has dropped; the interest banks pay for the money they borrow has dropped; but, strangely, credit card interest rates never dropped. In fact, they have gone up since 1981.

What is the message from all of this? The credit card industry is ripping off the American consumer, and there is no question about it. The American consumer is being victimized. The argument being made that the American consumer could go elsewhere for a card or simply not use it is fallacious. This is the way of life in America. The credit card system is here to stay. The notion of boycotting credit card use—while I appreciate the symbolic effect of it—would simply not work. I don't know how you discipline yourself and not have a credit card, Mr. Chairman.

But most of us in the Congress and most people in other professions have credit cards, and tearing it up would cause a great inconvenience. People have to be protected from those exploiters. And that is the important notion here. They are being ripped off to the tune of $2 billion a year. That is the difference between the $6 billion a year in interest charges now being paid by credit card users and the $4 billion a year they would be paying under legislation I have authored to lower rates to more reasonable levels.

Like most of the other 98.9 million credit card users in this country, I have long griped about high interest on my credit card accounts, but I more or less accepted it as a fact of life. That is until I read a New York Post article earlier this year telling me that not all banks have to charge nearly 20 percent on credit cards to earn a profit. In fact, the article reported that in 1982, the State of Arkansas capped its credit card interest rates at 5 percentage points above the Federal Reserve's discount rate. So that gives "lie" to the contention by the lending institutions that they need these extraordinary interest rates to cover their expenses. That is absolutely untrue, because the banks in Arkansas are not complaining about that 5-percent interest rate cap.

This translates into a 12.5-percent cap under present conditions compared to a national average of 18.6 percent. That is obscene. It is outrageous. Let's get back to the street again, and the seller of drugs. He has complete control of the drug addict. That addict is virtually helpless. He can charge anything he wants, and they will pay, and so be it here with credit cards. It is incumbent upon the Congress to do something about it.

The article went on to say that even with this cap, Arkansas banks were still making a healthy profit on their credit card business. In fact, it quoted one Arkansas banker as saying, "Sure we are making money, not as much as we would like, but we are not complaining." My immediate reaction was that if it can work in Arkansas, it should be able to work elsewhere.

Now, of course, people can say, "Well, why not just go to Arkansas?" Well, why should we have to go to Arkansas? I am a holder of several credit cards, and so are many other people. Why should we have to go elsewhere? We should not have to go to Arkansas, although I would suggest that we do. Arkansas is prepared to give you a credit card with a 12.5-percent cap, and the user of credit cards are foolish not to take advantage of it. But, why should we do that and hurt our individual jurisdictions?

Let the bankers and the lenders in this case moderate their position. In February I authored a bill, a bill I am proud to say you cosponsored, Mr. Chairman, along with 29 of our colleagues from both sides of the aisle. This measure would establish a national cap on credit card interest rates at 5 percent above the Federal Reserve's discount rate, which presently stands at 7.5 percent. Simple arithmetic tells us that, like in Arkansas, this would translate into a 12.5 national credit card interest rate cap under current conditions. This is in sharp contrast to the 18.6 nationwide average that currently exists.

Why tie credit card interest rates to the discount rate? Quite simply, this standard reflects what banks are paying for the money they borrow from the Federal Reserve. This is the same money the banks turn around and lend to their customers, including their credit card customers. It is generally indicative of current marketing conditions, and it is the same standard that has worked so successfully in capping Arkansas credit card rates.

Why a 5-percent credit card cushion? Admittedly, credit card users have certain costs to cover such as administative expenses, and fraud and abuse losses. My research indicates a 5-percent cushion is more than enough to cover these costs plus allow for a healthy margin of profit. After all, would Arkansas banks be welcoming out-of-State business or remain in the credit card business at all if this were not true?

At this time, Mr. Chairman, I want to point out that my bill does not distinguish between bank-issued credit cards and non-bank-issued credit cards. However, it was brought to my attention after the introduction of H.R.1197, that the cost of money and other credit card related expenses are not always the same for both banks and other issuers of credit cards.

I believe this matter deserves some further study before we decide whether or not to treat bank cards and nonbank cards the same. Otherwise, though, I believe we know more than is necessary to justify a nationwide cap on credit card interest.

Mr. Chairman, this chart tells the story. In August 1981, banks were paying 14 percent for the money they borrowed and they were charging their credit card customers 17.78 percent, a reasonable 3.78 difference. Today, the banks are paying 7.5 percent for the money they borrow, but they are charging their credit card customers 18.6 percent. That is an intolerable 11.1 percent difference.

The banks tried to tell us their administrative costs and fraud losses are up. Forget it. That is nothing more than a smokescreen.

What does this 11.1 percent really represent? Profits for the credit card issuers, plain and simple.

All we have to do is look at this chart, which shows the most recent earnings for the major credit card issuers, to know that it is greed, Mr. Chairman, it is greed. That is all it is. Greed on the part of the issuers, nothing else, pure and simple. That is the only explanation for the high credit card interest rates.

Consider, for instance, that at Citicorp, our Nation's largest credit card bank issuer, they reported a 13-percent net earnings increase overall last quarter with a 34-percent increase in its consumer banking operations.

Chemical Bank, the Nation's number four credit card bank issuer, reported a 27.5-percent credit earnings increase. No. 6, Manufacturers Hanover, gained 24.3 percent, and No. 5, Chase Manhattan, outdid them all with a whopping 105-percent earnings increase.

The New York Times told the story very concisely in their recent headline that read, "Big Banks Basking in Profits." The article that followed pointed out that as a group, banks are currently among the most prosperous businesses in the Nation. And I have no quarrel with business being prosperous, but I certainly think there is a question of reasonable degree of profits insofar as the consumer is concerned.

How has the credit card industry been able to get away with this obvious gouging of the American consumer? The reasons are several.

The banks point to record-high credit card spending and argue there is consumer acceptance of the interest rates they charge. Such logic is laughable.

I am far more inclined to agree with Robert Heady, publisher of Bank Rate Monitor, who says the society has become addicted to plastic. We Americans have become so dependent on credit cards that we are hostages to the industry that sells them.

Admittedly, the consumer must bear some of the blame for the high credit card interest rates. We could simply not use credit cards or we could go to the trouble of shopping around for that elusive good deal. But the banks, like the old-time shysters, tend to distort our good judgment.

How many of us in this room today are carrying credit cards that simply arrived at our homes in the mail, without any application on our part? I dare say quite a few.

Preapproved credit card mailings are one of the best gimmicks of the trade. They sucker people into using a credit card without any comparative shopping on the part of the consumer, because, let's face it, if somebody hands us a $2,000 line of credit with no muss and no fuss, it is pretty hard to turn it down.

We certainly don't get home mortgages and auto loans mailed to us preapproved. We have to shop for them. And I don't think it is any coincidence that interest on those items is down.

These preapproved credit card mailings also touch on another problem. The banking industry blames increasing losses due to fraud as a major reason for exorbitant credit card interest rates. But the American Bankers Association attributes these growing losses to the banks' aggressive solicitations, using—get this—preapproved credit card mailings.

Well, if that is so and if the credit card industry is so sure that the competitive market can take care of itself, then maybe we should simply do away with preapproved credit card mailings. I would be interested to hear the ABA comment on that proposal, Mr. Chairman.

Most of us are familiar with the popular advertising slogan that says "an educated consumer is our best customer." I would suggest an educated consumer would be the credit card industry's worst consumer.

Many consumers don't even know how much interest they pay on credit cards. Until recently, credit card interest rates were one of the best-kept secrets going. Those that do know their interest charge and want to do something about it don't know how.

For example, how many of us were aware that any New Yorker, let's say, could apply to a bank in Arkansas for a credit card? Not many, I am sure. And how many of us simply shrug off the interest rate when we first get a credit card, confident that we will pay off our account in full each month?

Well, the facts tell us only about one third of all credit card users pay off their total bill each month. But even these consumers are not necessarily protected. More and more banks have found they can make money off these people, too, by simply charging interest beginning on the date of posting.

Some have suggested we should leave this problem for the States to address. Well, the problem has been with us for some time and quite frankly the States have done very little to respond.

According to figures published this fall by Bank Card Holders of America, only three States, Alaska, Arkansas, and Washington, have credit card interest rate ceilings below 18 percent, and 17 States have no limit at all. My home State of New York has a 25-percent cap and New Jersey has a 30-percent cap—the highest in the country.

Obviously, the States are not providing the necessary protection for the consumer. But, in all fairness, should we really expect them to?

Consider that in 1980, after losing a battle with the New York State Legislature over the capping of credit card interest rates, Citibank moved its credit card operation to South Dakota, where there is no limit on the amount of interest Citibank could charge its customers. It was a major blow to my State, just as it was to Maryland when their banks decided to move their credit card subsidiaries to Delaware.

That gives you the nature of the thinking by the lenders in this credit card business. It becomes more apparent with each such revelation.

Unless all the States are forced to use one ceiling, as proposed in my bill, there will always be the threat of one State luring credit card business from another. That can and should be avoided by a federally imposed ceiling.

Can we expect the banking industry to lower credit card interest on their own? I think not.

Manufacturers Hanover Trust—to their credit—recently lowered their rate by 2 percentage points to 17.8. I commended them for that action, but no other major banks have followed their lead, because they are unwilling to voluntarily slow down the money machine that the credit card business has become. Ask them to take money out of their pocket, and they won't do it until somebody forces them to. That is why we are here today.

Most said they have no plans to do that. And, let's be honest, banks should be able to do a lot better than a 17.8 interest charge.

I tend to agree with the midwestern banker recently quoted in Time magazine as saying, "Why should institutions lower their credit card rates? They are growing fat on interest income, and until competitive pressures force a cut, they are not going to give up the golden egg." I think that is quite apparent.

Mr. Chairman, other proposals to cap credit card interest rates will be discussed today. Quite frankly, I do not want to suggest that the approach I offered is any more perfect than the others. I will let you and your subcommittee be the judge of that.

But it is obvious, Mr. Chairman, that without the introduction of this legislation and without genuine congressional concern, as demonstrated by today's hearing, we certainly could not even hope for any positive action by the credit card industry.

Now, at least, there is that hope, especially since the American consumer is becoming better informed about how they too can exert some pressure on credit card interest rates.

Mr. Chairman, thank you very much for this opportunity to address your subcommittee, and I commend you once again for your pioneer effort on behalf of the consumer. As you stated at the outset, you are realistic and you are practical.

There is no question in my mind that the issue here today has sufficient merit to have Congress take some action. But I am fearful of the awesome power possessed by the banking industry. I sincerely hope that it is not wielded in such a fashion as to impede the action of Congress in correcting this terrible, terrible situation.

Thank you, Mr. Chairman.

[The prepared statement of Congressman Biaggi follows:]

NEWS

FROM CONGRESSMAN

MARIO BIAGGI

19TH CONGRESSIONAL DISTRICT, N.Y. BRONX AND YONKERS

October 29, 1985

TESTIMONY IN SUPPORT OF H.R. 1197-- TO CAP CREDIT CARD INTEREST RATES

PRESENTED BEFORE THE HOUSE BANKING SUBCOMMITTEE ON CONSUMER AFFAIRS AND COINAGE

BY U.S. REP. MARIO BIAGGI

Mr. Chairman, it is indeed an honor to come before your subcommittee today and discuss what I know is an issue of mutual concern--namely, the exorbitant interest rates consumers are being forced to pay on their credit card accounts. Your longstanding concern for the American consumer, Mr. Chairman, is well documented and this hearing today is totally consistent with that record.

I intend to be brief, Mr. Chairman, because quite frankly the case in support of a national cap on credit card interest rates is easily made. Since 1981, interest on home mortgages has dropped; interest on auto loans has dropped; interest on individual savings has dropped; the interest banks pay for the money they borrow has dropped; but strangely, credit card interest rates never dropped--in fact, they have gone up since 1981.

What is the message from all this? The credit card industry is ripping off the American consumer at the rate of $2 billion a year! That is the difference between the $6 billion a year in interest charges now being paid by credit card users (according to the Consumer Federation of America), and the $4 billion a year they would be paying under legislation I have authored to lower rates to more reasonable levels. It should be noted that these figures do not include the $2-3 billion that consumers are being forced to pay in annual administrative fees.

Like most of the other 98.9 million credit card users in this country (according to The Nilson Report), I have long griped about the high interest on my credit card accounts, but I more or less accepted it as a fact of life. That is until I read a New York Post article earlier this year telling me that not all banks have to charge nearly 20% interest on credit cards to earn a profit. In fact, the article reported that in 1982 the State of Arkansas capped its credit card interest rates at five percentage points above the Federal Reserve's discount rate. This translates into a 12.5% cap under present conditions. The article went on to say that even with this cap, Arkansas banks were still making a healthy profit on their credit card business. In fact, it quoted one Arkansas banker as saying. "Sure, we're making money--not as much as we would like, but we're not complaining." My immediate reaction was if it can work in Arkansas, it should be able to work elsewhere.

So, in February, I authored a bill, H.R. 1197--a bill I am proud to say that you cosponsored, Mr. Chairman, along with 29 of our colleagues from both sides of the aisle. This measure would establish a national cap on credit card interest rates at 5 percentage points above the Federal Reserve's discount rate, which presently stands at 7.5%. Some simple arithmetic tells us that, like in Arkansas' case, this would translate into a 12.5% national credit card interest rate cap under current conditions. This is in sharp contrast to the 18.6% nationwide average interest rate being charged on bank-issued credit card accounts.

I want to clarify a point that has caused some confusion about my bill, Mr. Chairman. H.R. 1197 specifically mentions the "discount rate on ninety-day commercial paper." Since the drafting of this legislation, I have been informed by officials at the Federal Reserve Board that this is an archaic way of referring to what is more commonly known as the Federal Reserve's discount rate, or the discount rate for short-term adjustment credit, as it is referred to in the Federal Reserve Bulletin. In theory, the discount rate could vary among the 12 regional Federal Reserve banks, but in practice the discount rate is the same at each of the Federal Reserve banks. Let me emphasize that my bill does not suggest that the cap on credit card interest rates should be tied to the rate on commercial paper.

Why tie credit card interest rates to the discount rate? Quite simply, this standard reflects what banks are paying for the money they borrow from the Federal Reserve. This is the same money the banks turn around and lend to their customers, including their credit card customers. It is generally indicative of current market conditions, and it is the same standard that has worked so successfully in capping Arkansas credit card rates.

Why a five percentage point cushion? Admittedly, credit card issuers have certain costs to cover in the interest they charge, such as administrative expenses and fraud and abuse losses. My research indicates that a five percent cushion is more than enough to cover these costs, plus allow for a healthy margin of profit. After all, would Arkansas banks be welcoming out-of-state business, or even remain in the credit card business at all, if this were not true?

Although the precise figures are unavailable, James McDermott of Keefe, Bruyette & Woods Inc., a brokerage specializing in bank stocks, estimates that administrative and fraud costs account for about 3 to 4 percentage points, which means that a five percent cushion, as I have proposed, would allow one to two percentage points for profit, a healthy margin when you consider that each percentage point of credit card interest represents more than $500 million a year industry-wide (according to the Consumer Federation of America).

At this time, Mr. Chairman, I want to point out that my bill does not distinguish between bank-issued credit cards and nonbank-issued credit cards. Simply put, the figures indicate that the present rates for both are far higher than they should be--with nonbank-issued rates generally the highest--and I believe both should be capped. However, it was brought to my attention after the introduction of H.R. 1197 that the cost of money and other credit card related expenses are not always the same for both banks and other issuers of credit cards, and I believe this matter deserves some further study before we decide whether or not to treat bank cards and nonbank cards the same.

Let me add that this concern should not be shrugged off as an insignificant matter since the number of retail-issued credit cards (356.2 million) far outnumber bank cards (129.7 million), although more spending is done with bank cards ($112.5 billion annually) than with reail cards ($83.8 billion annually). These figures, which were reported for 1984 in The Nilson Report, do not include oil, phone, travel and entertainment, or other types of credit cards.

Otherwise, though, I believe we know more than is necessary to justify a nationwide cap on credit card interest. Consider, for example, that banks are now paying 6.5 percentage points less for their money than they did in August 1981, when the discount rate peaked at 14%. Yet, the banks are turning right around and charging their credit card customers more. This chart tells the story. In August of 1981, banks were paying 14% for the money they borrowed, and they were charging their credit card customers 17.78%--a reasonable 3.78% difference. Today, the banks are paying 7.5% for the money they borrow, but they are charging their credit card customers 18.6%--an intolerable 11.1% difference.

The banks try to tell us that their administrative costs and fraud losses are up. Forget it! That's nothing more than a smokescreen. What does this 11.1% difference really represent? Profits for the credit card issuers, plain and simple. With 708.6 million credit cards in the hands of American consumers (according to The Nilson Report), credit cards are obviously big business, and a lucrative one at that.

All we have to do is look at the most recent earnings reports for the major credit card issuers to know that greed is the only explanation for high credit card interest rates. Consider, for instance, that Citicorp, our nation's largest bank credit card issuer (with 13.58 million cards issued, according to The Nilson Report), reported a 13% net earnings increase overall, with a 34% increase in its consumer banking operations. Although Citicorp informs me they cannot give a precise breakdown, their credit card business obviously makes up a good part of that profit margin. How can it fail when they charge a 19.8% interest rate on their credit cards? Chemical Bank, the nation's number four ranked bank credit card issuer reported net earnings of 27.5%; number six Manufacturers Hanover gained 24.3%; and number five Chase Manhattan outdid them all with a whopping 105% earnings increase.

The New York Times told the story very concisely in a recent headline that read, "Big Banks Basking in Profits." The article that followed pointed out that "as a group, (banks) are currently among the most prosperous businesses in the nation . . . In contrast to generally lackluster earnings throughout most of corporate America, most of the largest commercial banks" (which are also some of the largest credit card issuers, Mr. Chairman) "managed to sport earnings gains that were well into the double digits." The article went on to report that analysts believe "the primary reason for the improved results was that banks' interest margin (the difference between what they pay and what they charge) . . . typically rose during the period . . . As rates fell, banks' cost of funds dropped, but the rates they charged customers on loans did not decline so quickly," the article explained.

How has the credit card industry been able to get away with this obvious gouging of the American consumer? The reasons are several. The banks point to record high credit card spending and argue there is consumer acceptance of the interest rates they charge. Such logic is laughable. I am far more inclined to agree with Robert Heady, publisher of Bank Rate Monitor, who says, "The society has become addicted to plastic." Quite frankly, we Americans have become so dependent on credit cards that we have become hostages to the industry that sells them.

There is no acceptance. The BankCard Holders of America, and the Consumer Federation of America have both demanded action to lower credit card rates. Further, a recent survey by BankCard Holders of America, a group representing more than 100,000 credit card users, revealed that 66% of those surveyed would switch banks if offered a lower rate. But, unfortunately, as much as the banks like to argue that consumers should simply shop around for a "good deal," in most cases there is no good deal to be found. The good deals that do exist can only be found if a consumer spends considerable time researching the rate ceilings in the 50 states; makes a number of long distance phone calls to the banks in the low ceiling states, like Arkansas; then sifts through the credit card application forms, paying close attention to the fine print. And, there is a strange irony in all this. We use credit cards mainly for convenience, but the process of getting one at a decent rate is anything but convenient.

Admittedly, the consumer must bear some of the blame for high credit card interest rates. We could simply not use credit cards, or we could go to the trouble of shopping around. But, the banks, like the old-time street shysters, tend to distort our good judgment. How many of us in this room today are carrying credit cards that simply arrived at our homes in the mail, without any application on our part? I dare say quite a few. Pre-approved credit card mailings are one of the best gimmicks of the trade. They sucker people into using a credit card without any comparative shopping on the part of the consumer, because let's face it, if somebody hands us a $2,000 line of credit with no muss and no fuss, it's pretty hard to turn it down. We certainly don't get home mortgages, or auto loans mailed to us pre-approved. We have to shop for them, and I don't think its any coincidence that interest on those items is down.

These pre-approved credit card mailings also touch on another problem, Mr. Chairman. The banking industry blames increasing losses due to fraud as a major reason for exorbitant credit card interest charges. But, the American Bankers Association attributes these growing losses to the banks' aggressive solicitations using--get this--pre-approved credit mailings.

Well, if that's so, and if the credit card industry is so sure that the competitive market can take care of itself, then maybe we should simply do away with pre-approved credit card mailings. I would be interested to hear the ABA comment on that proposal, Mr. Chairman.

Most of us are familiar with a popular advertising slogan by a local clothing chain that says, "An educated consumer is our best customer." Well, I would suggest that an educated consumer would be the credit card industry's worst customer. Many consumers don't even know how much interest they pay on credit cards. In fact, until recently, credit card interest rates were one of the best kept secrets going. Those that do know their interest charge and want to do something about it, don't know how. For example, how many of us were aware that a New Yorker, let's say, could apply to a bank in Arkansas for a credit card? And, how many of us simply shrug off the interest rate when we first get a credit card, confident that we will pay off our account in full each month? Well, the facts tell us that only about one-third of all credit card users pay off their total bill each month, but even these consumers are not necessarily protected. More and more banks have found they can make money off these people, too, by simply charging interest beginning on the date of purchase.

And, this is a concern that should not be overlooked, Mr. Chairman. Like many others, I am fearful that should the credit card industry be limited in the amount of interest they can charge, they will simply devise other ways of making up the difference. Eliminating the so-called "float" is one way, as some are already doing, and raising their annual fees is another. We must make it clear to the credit card issuers that such a response would not be tolerated by the Congress.

Some have suggested that we should leave this problem for the states to address. Well, the problem has been with us for some time now and, quite frankly, the states have done very little to respond. According to figures published this year by Bankcard Holders of America, only three states--Alaska, Arkansas and Washington--have credit card interest rate ceilings below 18%, and 17 states have no limit at all. My home state of New York has a 25% cap, and New Jersey has a 30% limit--the highest in the country. Obviously, the states are not providing the necessary protection for the consumer, but in all fairness, should we really expect them to?

Consider that in 1980, after losing a battle with the New York State legislature over lower credit card interest ceilings, Citibank moved its credit card operation to South Dakota, where there is no limit on the amount of interest Citibank could charge its customers. It was a major blow to my state, just as it was to Maryland when their banks decided to move their credit card subsidiaries to Delaware. Unless all the states are forced to use one ceiling, as proposed in my bill, there will always be the threat of one state luring credit card business from another. That can and should be avoided by a federally-imposed ceiling.

Can we expect the banking industry to lower credit card interest on their own? Manufacturers Hanover Trust recently lowered their credit card rate by two percentage points to 17.8%. I commended them for that action, but no other major banks have followed their lead and most have said they have no plans to. And, let's be honest, banks should be able to do a lot better than a 17.8% interest charge.

No, I tend to agree with a Midwestern banker, who was recently quoted in Time magazine as saying, "Why should (institutions lower their credit card rates)? They're growing fat on interest income, and until competitive pressures force a cut, they're not going to give up the golden egg."

One reporter recently told me that some bankers are arguing that lowering the rate on credit cards would result in costly administrative expenses and overall confusion, thus, they thought it would be best for everyone concerned to just leave the interest rates as they are. Seems kind of strange that the same arguments did not prevent the banks from raising their interest rate charges in the first place.

Mr. Chairman, other proposals to cap credit card interest rate ceilings will be discussed today. Quite frankly, I do not want to suggest that the approach I have offered is any more perfect than the others. I will let you and your subcommittee be the judge of that.

In fact, my objective is not necessarily the enactment of legislation; it is to see that a serious injustice is corrected. If credit card interest rates can drop to reasonable levels without the passage of a bill then so much the better. But, it is obvious, Mr. Chairman, that without the introduction of this legislation, and without genuine congressional concern, as demonstrated by today's hearing, we certainly could not even hope for any positive action by the credit card industry. Now, at least there is that hope, especially since the American consumer is becoming better informed about how they, too, can exert some pressure on credit card interest rates.

Thank you, Mr. Chairman.

Chairman ANNUNZIO. I thank my good friend from New York for his outstanding statement and for spelling out the problem that is before the Congress.

I want to assure him that this subcommittee will proceed not only with the hearings, but we will proceed in markup of legislation, and I intend to have some legislation before the House. Hopefully, win, lose, or draw, the consumers are going to have their day in court.

Chairman ANNUNZIO. Now, this morning I want to welcome a new member of the Federal Reserve Board to the subcommittee. Ms. Seger, is this your first appearance before the Banking Committee? I know it is your first appearance before the subcommittee.

Ms. SEGER. Yes, sir, it is.

Chairman ANNUNZIO. We want to welcome you and wish you well in your tenure with the Federal Reserve Board. Your entire statement will be made part of the record, and you can proceed in your own manner for 10 minutes, Ms. Seger.

STATEMENT OF HON. MARTHA R. SEGER, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Ms. SEGER. Thank you very much, Mr. Chairman.

It is a pleasure to be here today. I appreciate the opportunity to present the views of the Federal Reserve Board on two legislative proposals that would establish nationwide ceilings on credit card interest rates. Both bills would set floating ceilings on credit card rates that would supersede generally less restrictive State imposed limits.

Recently, a number of observers have noted that interest rates have edged up since the early 1980's, even though market rates, which represent funding costs, have fallen substantially. Some commentators have interpreted the resistance of credit card rates to downward pressure as an indication that the market for credit card lending is not competitive—a premise that underlies both bills. Although the stickiness of rates might lead some observers to conclude that competition is lacking, other characteristics of the market suggest that competition is intense. As my remarks will indicate, the Board believes that factors other than the level of competition explain the relative stability of credit card interest rates.

A large number of suppliers in a market usually is taken as a sign of competitive conditions. In this respect, there is no doubt that many commercial banks, retail stores and other firms currently offer credit cards of some kind to consumers. Moreover, what used to be known as bank credit cards are now issued by a growing number of credit unions, finance companies, savings and loan associations, and others. And the marketing practices of card issuers suggest a zeal for obtaining new customers that generally is associated with vigorous competition. In view of these indications of healthy competition, another explanation must be found for the lack of association between credit card rates and market interest rates.

Implicit in the idea that the variations in credit card finance rates should correspond closely to changes in market rates is the premise that the cost of funds is a dominant cost factor in providing credit card services. In fact, however, the cost of funds seems to be much less important in credit card lending than in other types of credit.

But an even more striking difference exists between credit card loans and other types of lending. The key characteristic of revolving credit plans is that the terms of repayment are quite flexible and at the discretion of the account holder. Excluding cash advances, which earn finance charges from the transaction date, most credit card plans charge interest only if cardholders pay less than the full amount billed during the period.

Available evidence suggests some credit cardholders, perhaps nearly 10 percent at any one time, do not use their credit cards at all. Of cardholders who use their credit cards, some surveys indicate that half usually pay off the entire balance when billed. Such customers generate no finance charge revenue to offset costs of processing, billing, or financing, although in the case of third-party credit cards, such as MasterCard and VISA, the card issuer would derive some income from the fees that merchants pay to help defray processing costs.

These considerations strongly suggest that the behavior of credit card rates cannot be properly evaluated by comparing them with a market rate of interest. A more meaningful measure is the net return after deducting the cost of funds and other expenses. Bank surveys suggest that for the period 1972 through 1984—in contrast to the higher gross finance rate on credit card indebtedness—average before-tax earnings have been substantially lower during most of the period for credit cards than for commercial or mortgage lending. Thus, there must be reasons other than a lack of competition that explain why, of late, credit card rates have not fallen much.

Viewed in this longer perspective, the question of why credit card rates have not dropped as sharply as other rates necessarily poses the analogous question of why credit card rates did not increase in previous years when other interest rates surged. Partly, as noted earlier, the stability of credit card rates reflects the lesser role of financing costs the overall cost function. It also reflects the impact of State-established statutory ceilings on interest rates.

In all but a few States, 18 percent per year was the upper limit on rates that card issuers could charge on credit card balances in the late 1970's when other rates were beginning to climb. Then, when market costs of funds rose sharply between 1979 and 1981 while credit card rates were restrained by the usury ceilings, marginal and even average net returns on credit card receivables at reporting banks turned negative. The reduced attractiveness of credit card lending prompted several fundamental realignments by card issuers, once it became clear that the adverse conditions were likely to persist.

Now that market costs of funds have moved to lower levels, and credit card programs generally have become profitable again, many credit card issuers have greatly intensified their efforts to market new credit card accounts and to encourage account usage. That is, credit card issuers in general have responded to falling financing costs not by reducing interest rates, but mainly by increasing the availability of credit cards; this reversed the curtailment of such credit that card issuers undertook as market rates moved up because, in many cases, they were unable to adjust revenues to match rising costs. Thus, it appears that much of the inertia in credit card rates may be attributable to the influence of restrictive rate ceilings.

Factors on the demand side of the market also may have contributed to the stability of credit card rates. Cardholders who either use their credit cards infrequently or usually pay off their bills in full are likely to be less concerned about the level of finance charges. Even cardholders who "roll over" their balances and pay finance charges may often be relatively insensitive to the rate of interest charged. In any case, credit card debt has expanded rapidly during the past 2 years—a sign that consumers nevertheless view credit card use as a desirable source of short-term financing despite what many regard as high rates of interest.

Moreover, the recent appearance of above-average returns to bank credit card lending may not lead to an immediate widespread reduction in rates. Credit card issuers may be uncertain whether favorable net returns will persist, especially given the continuing large Federal budget deficits. Until actions are taken to curtail the deficits and thereby reduce uncertainty about the likely future course of financing costs, many issuers may remain reluctant to cut finance rates much, if at all, in view of their experience with intense cost pressures in previous years. Instead of offering lower finance rates, creditors may choose to compete by easing credit standards somewhat or by making nonrate credit terms more attractive. Even so, one should keep in mind that finance rates on credit cards already have shown some tendency to decline.

An effort to establish a federally mandated ceiling on credit card interest rates can be expected to encounter difficulties. From experience with the imposition of credit controls in 1980 and the sharp, unexpected contraction in consumer spending that accompanied them, we know that regulatory measures can have unpredictable and unwanted consequences. Based on recent levels of 3-month Treasury bill rates and the discount rate, the ceiling for credit card rates under either of the proposed bills would be 12.5 to 13.5 percent, well below levels of bank finance rates that have been typical since credit cards emerged in the early 1960's as a major method of consumer financing.

Furthermore, imposition of stringent rate ceilings might be countered by adjustments in nonrate credit card terms. Some card issuers also might begin applying the reduced finance charges from the date of purchase, where permitted, rather than after the grace period expires, and might seek to increase merchant discount fees.

Turning to the central provisions of the two bills before the Congress, it should be emphasized that credit cards are issued by a broad variety of retail merchants and financial institutions that have different sources of funding and different liability structures. Under these circumstances, a single index rate would be unlikely to mirror changes in either marginal or average costs for such a diverse array of card issuers.

If the Congress should nonetheless decide to enact legislation, the Federal Reserve strongly recommends against designating the discount rate as an index for setting ceilings on credit card rates. The discount rate, as you know, is a tool of monetary policy that reflects broad, complex policy considerations. It would be wrong, in the Board's view, to employ a tool of monetary policy for this use.

Another question at issue is whether any regulation of credit card interest rates is more appropriately a matter for State or Federal intervention. The establishment of interest rate ceilings has long been a State prerogative and one that the Board feels should not be preempted lightly. Under the circumstances, the Board is inclined to respect the collective judgment of a growing number of States that higher, not lower, ceilings are appropriate to the viability of the credit card market and to note that these States retain the authority to lower the ceilings if convincing evidence of noncompetitive rate determination appeared.

In closing, then, I would like to reemphasize the Board's conviction that financial markets distribute credit most efficiently and productively when interest rates are determined without artificial restraints, insofar as possible. In the credit card business, the balance of the evidence suggests that reasonably competitive conditions exist, notwithstanding the lack of variation in finance rates. Furthermore, recent developments have reflected some tendency for credit card rates to decline. Efforts to constrain credit card rates through Federal regulation are likely to have undesirable side effects in the form of reduced credit availability or less efficient means of recapturing credit costs. Accordingly, the Board concludes that it would be inappropriate to impose a Federal ceiling on credit card rates.

Thank you very much.

[The prepared statement of Ms. Seger follows:]

STATEMENT BY MARTHA R. SEGER, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I appreciate the opportunity to appear before the Subcommittee to present the views of the Federal Reserve Board on two legislative proposals that would establish nationwide ceilings on credit card interest rates. One of these bills, H.R. 1197, would specify that the rate of interest on any credit card transaction could not be more than 5 percentage points higher than the Federal Reserve discount rate. The other bill, H.R. 3408, would limit the interest rate on credit card debt to 6 percentage points above the yield on 3-month Treasury obligations; this plan would not become effective if it were determined by the Federal Reserve that prevailing loan rates reflect the cost of funds to creditors and competition for credit card accounts.

Both bills under review today would set floating ceilings on credit card rates that would supersede generally less restrictive state-imposed limits. In the past, the Board has commented on similar proposals from time to time. In doing so, it has endorsed the principle that consumer loans and other types of credit are most fairly and efficiently allocated where there are no regulatory constraints on interest rates. Indeed, the Board has been concerned for some time about the adverse impact that rate ceilings can have on the availability of funds in local credit markets. On frequent occasions, it has stated its opposition to such artificial limits.

Recently, a number of observers have noted that interest rates on bank credit card credit have edged up since the early 1980s even though market rates, which represent funding costs, have fallen substantially. Some commentators have interpreted the resistance of credit card rates to downward pressure as an indication that the market for credit card lending is not competitive—a premise that underlies both bills. Although the stickiness of rates might lead some observers to conclude that competition is lacking, other characteristics of the market suggest that competition is intense. As my remarks will indicate, the Board believes that factors other than the level of competition explain the relative stability of credit card interest rates.

A large number of suppliers in a market usually is taken as a sign of competitive conditions. In this respect, there is no doubt that many commercial banks, retail stores, and other firms currently offer credit cards of some kind to consumers. Moreover, what used to be known as "bank" credit cards are now issued by a growing number of credit unions, finance companies, savings and loan associations, and others. Thus, there are likely to be a number of competing bank and retail credit cards available in almost any market area. Under these conditions, it seems doubtful that a credit card issuer could maintain a position of monopoly power.

Indeed, the marketing practices of card issuers suggest a zeal for obtaining new customers that generally is associated with vigorous competition. This behavior has been apparent in the heavy volume of solicitations for new accounts—often directed to residents who live outside the market areas typical of most retail deposit and credit services. In view of these indications of healthy competition, another explanation must be found for the lack of association between credit card rates and market interest rates.

Implicit in the idea that variations in credit card finance rates should correspond closely to changes in market rates is the premise that the cost of funds is a dominant cost factor in providing credit card services. In fact, however, the cost of funds seems to be much less important in credit card lending than in other types of credit. For credit card plans, the bulk of total costs is composed of operating costs incurred for processing transactions, monthly billings, and evaluating credit applications, along with costs associated with delinquent accounts and credit losses. These cost factors vary in ways that usually differ from the pattern followed by changes in market costs of funds.

The Federal Reserve System each year surveys a number of commercial banks to obtain information about their costs of providing various services. From these average cost data, published under the title Functional Cost Analysis, the importance of financing costs and other costs can be compared for credit card operations and for other kinds of bank lending. During the period 1974 through 1984, financing costs averaged only about three-tenths of total expenses, before taxes, for the credit card function at participating medium- and large-sized banks that issue credit cards. By comparison, financing costs at banks in the same size classes accounted for more than three-quarters of total costs of the commercial lending function, and for nearly nine-tenths of total costs of mortgage lending. Studies of credit card operations at retailers likewise have shown that funding costs are less important than operating and collection costs.

But an even more striking difference exists between credit card loans and other types of lending. The key characteristic of revolving credit plans is that the terms of repayment are quite flexible and at the discretion of the account holder. Excluding cash advances, which typically earn finance charges from the transaction date, most credit card plans charge interest only if card holders pay less than the full amount billed during the period. Thus, unlike other kinds of credit, the way the credit card holder uses the account determines how much—and, indeed, whether—interest revenue is earned from the account.

Available evidence suggests that some credit card holders—perhaps nearly 10 percent at any one time--do not use their credit cards at all. These nonusers produce no finance charge revenue to offset costs of establishing and maintaining their accounts. Of cardholders who use their credit cards, some surveys indicate that half usually pay off the entire balance when billed. These customers also generate no finance charge revenue to offset processing, financing, and billing costs, although in the case of third-party credit cards such as Mastercard and Visa the card issuer would derive some income from the fees that merchants pay to help defray processing costs.

These considerations strongly suggest that the behavior of credit card rates cannot be properly evaluated solely by comparing a credit card rate with a market interest rate. Doing so would overlook the fundamental differences in the behavior of costs and revenues between credit card operations and other types of lending—namely, that funding costs are a lower share of total costs for credit card lending, and that some credit-card borrowers pay little or no interest. A more meaningful rate comparison requires a measure that takes account of these differences.

One such measure is the net return after deducting the cost of funds and other expenses. Again, the Functional Cost Analysis statistics for respondent banks provide some basis for comparison among types of lending. Data for the period 1972 through 1984 suggest that--in contrast to the higher gross finance rate on credit card indebtedness--average before-tax earnings have been substantially lower during most of the period in the case of credit card operations than for commercial or mortgage lending. These figures, of course, include periods of relatively low or negative returns on credit card lending, such as in 1980, and periods such as last year when the yield for the credit card function exceeded that for commercial loans and mortgage loans. Over the longer term, returns on credit card plans have not been out of line with other types of lending; as indicated, margins actually have been lower on average in the credit card area. Thus, there must be reasons other than a lack of competition that explain why, of late, credit card rates have not fallen much.

Viewed in this longer perspective, the question of why credit card rates have not dropped during the recent period as sharply as other rates necessarily poses the analogous question of why credit card rates did not increase in previous years when other rates surged. Partly, as noted earlier, the stability of credit card rates reflects the lesser role of financing costs in the overall cost function. It also reflects the impact of state-established statutory ceilings on interest rates.

In all but a few states, 18 percent per year was the upper limit on rates that card issuers could charge on credit card balances in the late 1970s when other rates were beginning to climb. Judging from the Functional Cost Analysis, average returns to banks on credit card operations in most prior years had been no higher than net earnings on other major forms of lending. Then, when market costs of funds rose sharply between 1979 and 1981 while credit card rates were restrained by the ceilings, marginal and even average net returns on credit card receivables turned negative.

The reduced attractiveness of credit card lending prompted several fundamental realignments by lenders, once it became clear that the adverse conditions were likely to persist. Some commercial banks, for instance, relocated their credit card operations to states, such as South Dakota, where there were less restrictive rate ceilings or none at all. At the same time, many state legislatures acted to raise their rate ceilings or--as at least a dozen states have done--eliminate them altogether. Many credit card issuers during this period of high market interest rates began charging annual fees on credit card accounts. And, though precise measurement is difficult, many diversified creditors such as banks tightened their lending standards and deemphasized their credit card business in favor of other types of lending that seemed more profitable at the time. Some institutions stopped accepting any new credit card accounts.

Now that market costs of funds have moved to lower levels, and credit card programs generally have become profitable again, many credit card issuers have greatly intensified their efforts to market new credit card accounts and to encourage account usage. That is, credit card issuers in general have responded to falling financing costs not by reducing rates, but mainly by increasing the availability of credit cards; this reversed the earlier curtailment of such credit that card issuers undertook as market rates moved up and many card issuers were unable to adjust revenues to match rising costs. Thus, it appears that much of the inertia in credit card interest rates may be attributable to the influence of restrictive rate ceilings imposed by the states.

Of course, rate ceilings in the credit card market are considerably less pervasive than they were prior to 1980. As mentioned, a number of states have raised or removed applicable rate ceilings, or have permitted lenders to charge annual fees for credit card accounts. These changes, in addition to the declines in the cost of funds, may help explain the rise in the overall net return, before taxes, on credit card plans at respondent banks to about 3-1/2 percent in 1984. So it may be that a growing number of credit card issuers now are in a position to consider offering somewhat lower finance rates to credit card holders.

Factors on the demand side of the market also may have contributed to the observed stability of credit card rates. As previously mentioned, a substantial proportion of card holders either use their credit cards infrequently or usually pay off their bills in full; these holders are likely to be largely unconcerned about the level of finance charges.

Even card holders who "roll over" their balances and pay finance charges may often be relatively insensitive to the rate of interest charged. Other features of credit card borrowing, such as convenience and suitability for small transactions, may outweigh any rate disadvantage. In any case, credit card debt has expanded rapidly during the past two years--a sign that consumers view credit card use as a desirable source of short-term financing despite what many observers regard as high rates of interest.

Furthermore, the recent appearance of above-average returns to bank credit card lending may not lead to an immediate, widespread reduction in rates. Credit card issuers may be uncertain whether such favorable conditions will persist, especially given the continuing large federal budget deficits. Until actions are taken that curtail the deficits and thereby reduce uncertainty about the likely future course of financing costs, many credit card issuers may remain reluctant to cut finance rates much if at all, especially in view of their experience with intense cost pressures in previous years. Also, instead of offering lower finance rates, creditors may choose to compete by easing credit standards somewhat or by making nonrate credit terms more attractive.

In this connection, one should keep in mind that finance rates on credit cards already have shown some tendency to decline. One large bank announced in early October that it had cut its finance rate; at the same time, it established separate fees for some types of services for which credit cards are used. Various issuers have adopted floating finance rates of the general kind that are proposed by the legislation under your review. However, those adjustable rates often have been paired with annual fees. This degree of diversity and experimentation may be regarded as further evidence of active competition.

An effort to establish a federally mandated ceiling on credit card interest rates can be expected to encounter difficulties. From experience with the imposition of credit controls in 1980 and the sharp, unexpected contraction in consumer spending that accompanied them, we know that regulatory measures can have unpredictable and unwanted consequences. Setting a federal ceiling rate of interest on credit card debt below those that currently prevail in many states would likely reduce the amount of credit made available. Moreover, such a curtailment would likely fall most heavily on less affluent borrowers with relatively limited access to other sources of credit. Based on recent levels of 3-month Treasury bill rates and the Federal Reserve discount rate, the ceiling for credit card rates under either of the proposed bills would be 12-1/2 to 13-1/2 percent, well below the finance rates that have been typical since credit cards emerged in the early 1960s as a major method of consumer financing.

Furthermore, imposition of stringent rate ceilings might be countered by adjustments in nonrate credit card terms such as increased annual fees, processing charges levied on each purchase or cash advance, and penalties for late payments or for exceeding the authorized credit limit. Some card issuers also might begin applying the reduced finance charges from the date of purchase, where permitted, rather than after the grace period expires, and might seek to increase merchant discount fees.

Turning to the central provisions of the two bills before the Congress, it should be emphasized that credit cards are issued by a broad variety of retail merchants and financial institutions that differ both as to their sources of funding and their liability structures. Under these circumstances, a single index rate would be unlikely to mirror changes in either marginal or average costs for such a diverse array of card issuers. In any case, short-term rates, such as on Treasury bills, fluctuate a good deal more widely than costs of funds of most lenders. They do so because a lender's overall average cost of funds at any point is partly determined by previously issued liabilities, and because market rates on longer-term liabilities--which make up part of the cost of funds--typically vary less than shorter-term rates.

If the Congress should nonetheless decide to enact legislation, the Federal Reserve strongly recommends against designating the discount rate as an index for setting ceilings on credit card rates. The discount rate, as you know, is the interest rate charged by the Federal Reserve Banks on extensions of short-term credit to depository institutions. Because it typically applies to very short-term loans, the discount rate is an inexact measure of either marginal or average costs of loanable funds, which may reflect borrowing at a wide range of maturities. Furthermore, the discount rate is a tool of monetary policy. As such, it is an administered rate that reflects broad policy considerations that frequently are complex, and so may deviate from other market rates, even those for instruments of comparable maturity. It would be wrong, in the Board's view, to employ a tool of monetary policy for this use.

Another question at issue is whether any regulation of credit card interest rates is more appropriately a matter for federal or for state intervention. The establishment of interest rate ceilings has long been a state prerogative, and one that the Board feels should not be preempted lightly. In recent years, virtually every state has reviewed and overhauled its laws regulating consumer interest rates. After studying the situation in their own jurisdictions, many of these states have opted to raise or remove interest rate ceilings for credit card borrowings. The Board is inclined to respect the collective judgment of a growing number of states that higher—not lower—ceilings are appropriate to the viability of the credit card market, and to note that these states retain the authority to lower the ceilings if convincing evidence of noncompetitive rate determination appeared.

In closing, I would like to reemphasize the Board's conviction that financial markets distribute credit most efficiently and productively when interest rates are determined in markets that are as free from artificial restraints as possible. In the credit card business, the balance of the evidence suggests that reasonably competitive conditions exist, notwithstanding the lack of variation in finance rates. Furthermore, recent developments have reflected some tendency for credit card rates to decline. Efforts to constrain credit card rates through federal regulation are likely to have undesirable side-effects in the form of reduced credit availability or less-efficient means of recapturing credit costs. Accordingly, the Board concludes that it would be inappropriate to impose a federal ceiling on credit card rates.

Chairman ANNUNZIO. Thank you for your statement.

Mr. Biaggi, banks continue to tell us how expensive it is to lend to consumers, and that is the reason consumer rates are so high. But rates on other types of consumer credit, even unsecured personal loans, have come down over the past few years while credit cards have not.

In your opinion, is there any reason for keeping credit card rates high other than record profits?

Mr. BIAGGI. Thanks for the home run pitch, Mr. Chairman. There doesn't seem to be any. We just heard from a representative of the Federal Reserve, Ms. Seger, who said that discount rates shouldn't be used as a basis of capping rates and that the expenses associated with administration and losses are a problem. I recall early on, when the banks wanted to increase their interest rates, they said the cost of money was too high, and it was going up. Well, I mean, you can't have it both ways. If the rationale was proper then and it made sense to raise rates—and I couldn't disagree with that rationale—then how can we argue now that the bank's cost of money, the discount rate, shouldn't be used as a basis? They are getting money for considerably less. They are paying less for money—6.5 percent less now than they were then.

I think another answer that should not be ignored is that it works in Arkansas, it works in Alaska and it works in Washington. They are not charitable organizations. They make money. They are satisfied with the proposition. They would like to make more, according to those statements, but they are making money now. I don't understand—don't we have the same conditions in other States? You are talking about three States of our Nation. They have the same conditions, the same administrative expenses, the same fraudulent users of cards, the same people who abuse, and they are making money. So I don't understand the rationale whatsoever.

A comment was made that recent developments indicate there is a trend toward reduced interest rates. The only recent development I heard of was Manufacturers Hanover reducing its rate by some 2 percent, from 19.8 to 17.8. It is the only bank I heard of. Is there a movement underway? I certainly wish there was, and my colleague, Mr. Schumer, said the same thing. He was hoping there would be a response. There has been no response. And there will not be a response. Why should they turn off the money machine unless they are required to?

Chairman ANNUNZIO. The discount rate has always played a very important factor. Today the discount rate is 7.5 percent, and usually banks make loans with a spread of 4 or 5 percent, so you find the rate at about 11 or 12 percent. The only thing I know of, in these credit cards, the rate is way out of control.

Mr. BIAGGI. It has gone up rather than down.

Chairman ANNUNZIO. Sure it has gone up. I think one word in your statement you described it, it is greed. People want to continue exploiting other people and continue to make money.

Mr. SCHUMER. Mr. Chairman, if I might just respond to your question.

Chairman ANNUNZIO. I have a question for you. Well, go ahead.

Mr. SCHUMER. I want to respond to the argument that companies are competing by issuing new cards. There are 200 major credit card issuers in America. Why are they all competing in the same way? If there is real competition, why haven't a couple of them, instead of sending everyone a card in the mail, instead of appealing to the sector of the market that can least afford credit, lower their rates instead.

It is like when the big auto companies were all competing against each other in the 1970's. Yes; in certain ways they were really competing, but none of them built a little car, and that is why they got clobbered. I find it amazing that it could be stated that there is adequate competition when none of the major issuers, until congressional pressure evolved, tried to lower their rates. Let 195 compete by offering more credit. Where are the two or three or four who say, "We are going to lower our rate to 16 percent and see if we can win more consumers that way."

Chairman ANNUNZIO. Do you think, Mr. Schumer, the credit card industry is sufficiently competitive when it comes to annual fees on credit cards?

Mr. SCHUMER. Certainly not, Mr. Chairman. Let one of the banks make the plunge. Let's see three or four major credit card issuers lower their rates and give consumers an option, a lower rate as opposed to other things like easier credit and then I'll believe there is some competition.

I am a believer in the free market, but when you come to the conclusion that there is no market, then as a last resort Congress has to act.

I designed my bill hoping that the cap it contains wouldn't go into effect. I designed my bill to say that a Government ceiling is imminent, and to generate some competition. That is my hope. I think it is all of our hopes. Government doesn't regulate these matters very well, but I will tell you one thing, it would do it a lot better than what is going on now where there is no competition at all. It is utterly appalling. Creditors say, on the demand side, consumers don't want lower rates. I say let someone try it. Creditors say, on the supply side, there is lots of competition in issuing more cards to people. Fine. There aren't 3 credit issuers out of 200 making the decision to lower rates. Where is somebody taking the plunge?

There may not be 200 issuers on the telephone talking to each other saying "We are going to keep our rates at 19 percent." But there is a tacit understanding that since this is the goose that lays the golden egg, nobody ought to lower the rates. I find it interesting that Manufacturers Hanover, the one bank that lowered its rate, wouldn't come here to testify today. That is something of an indication of the collegiality within the industry.

Chairman ANNUNZIO. Mr. Hiler.

Mr. HILER. I thank the chairman.

I don't know, maybe my staff is unusual in some of the solicitations they get, I don't know, but here is one from Chevy Chase S&L. This was June 7, 1985. They have an APR of 14 percent. I have one here, Dryfus Gold Check, 16.9; Bank of New York, 16.98. I am just not sure, Congressman, that Congress stepping in and setting the rate is going to solve the problem.

It would seem to me that what is probably going to happen, if Congress stepped in and set a rate, is that a lot of people would no longer get credit cards. Congressman Biaggi, you would like to see the rate at about 5 points over the discount rate, which today would make it about 12.5 points, which is about the same rate that a 30-year fixed mortgage is. Do you think that a credit card loan is as secure as a 30-year mortgage?

Mr. **Biaggi**. No; it is not.

Mr. **Hiler**. Why should they have the same rate?

Mr. **Biaggi**. Given the experience of three States that make money with it, it is not speculation or a hypothetical. It is an experience. My bill does mention a 5-percent cap above the discount rate. But in the end, it will be for the subcommittee to make the determination. I am not wedded to 5 percent, I am wedded to the notion that the present practice should cease, the present exploitation should cease.

The fact is we have experience in three States that show it is profitable. To me, that is a great barometer.

Mr. **Hiler**. I am sure you can—if I were a bank and someone came in and said, "Look, you can only charge 12.5 percent on the credit card loans that you have outstanding," my first reaction would be "I will do everything possible to eliminate from my credit card ranks those people for whom there might be increased risk." In other words, I will try to make sure everyone who has one of those cards is, in fact, as secure as the person holding the 30-year mortgage.

And so my first reaction would be to eliminate many people from having credit cards. Do you see that as a problem, that if we impose a rate ceiling, many people who probably need the credit card far worse than I would are suddenly going to be without the credit card?

Mr. **Biaggi**. You might recall that I pointed to cards in 1981 when the banks paid some 14 percent for their money—that was the discount rate—and the banks were charging 3.78 percent more, and they were satisfied at that point. So they should not have a problem with a 5-percent credit card cap above the discount rate. That would give them an even greater margin of profit than they had in 1981.

Mr. **Hiler**. Mrs. Seger has testified—I might ask a question, you made a point over the last 10 or 12 years, 1972 to 1984, that the return on credit cards has been fairly even when you take out the cyclical changes.

Would you care to comment further on that?

Ms. **Seger**. It hasn't really been even. My point was that average before-tax earnings for commercial bank credit card plans have been lower than for commercial and mortgage loan at banks, and that this evidence is consistent with other indications of strong competition in the credit card market. The composition of the sample varies year to year, and also there are cyclical changes, so that is why we did an average for a longer period.

For example, in 1980 when monetary policy was very tight and market rates rose very rapidly to extraordinary heights, this created problems for credit card issuers, and put them in a severe profit squeeze. Then as market rates went down, some of that pressure was relieved. So, there are yearly differences in the results, ranging as I said, from actually losing money in 1 year to last year, which was a pretty good year.

Mr. **Hiler**. So if we take a universe of time that doesn't include several of these cycles, up and down, and instead look at a 4- or 5-year cycle, when rates were high and the credit card issuers were losing money or in a very low profit position, we probably aren't getting a fair assessment of what has been happening in the industry over a period of 10, 12, 14 years.

Ms. **Seger**. That is right.

Mr. **Biaggi**. I will concede that credit card levels have been maintained at pretty consistent levels over the last 4 years. But I think the real problem, and I understand the nature of the gentleman's concern——

Mr. **Hiler**. When you say profit rate, are you talking about spread——

Mr. **Biaggi**. Spread.

Mr. **Hiler**. Spread is not necessarily profit.

Mr. **Biaggi**. I understand the gentleman's concern with relation to the risk and abuse and things like that. But that developed because of the preapproved credit card mailings. They are trying to sweep up the whole world. The question is, Should we pay for that? Should everyone pay for that? Let them stop that practice, and they will find they won't have the same fraud and abuse losses, which would allow for continued profits at lower interest rates. That is why Mr. Schumer's proposal has considerable merit in that we should study the precise costs involved.

But, again, I refer back to the experience three States are already having. They are all engaged in the same credit card business as other States and, by their own admission, they are making money at the lower rate.

Mr. **Schumer**. I haven't seen Chevy Chase Bank putting ads on television or elsewhere about their credit cards. Look at the chart over there of the 10 major issuers. The only one that is slightly lower is Manufacturers Hanover. I am not saying that a few small banks do not have lower rates. I am talking about 96 or 99 percent of the industry, and that is what is important.

Obviously there are small people trying but the big banks are not. If that chart showed some disparity, if one was 21 and one was 17 and one was 14, fine. It is not. They are all the same. And as Congressman Biaggi's chart showed, profits have gone up. This is not cyclical. When the cost of money drops from 16 percent or 17 percent to 8 or 9 percent and the amount of fraud, has not increased tremendously, then the only answer can be that issuers are trying only to sell more and more of their credit cards. Certain issuers should compete that way. Let Cadillac compete with Lincoln, but let's have a few Chevies and a few Toyotas around, too. Let some other issuers compete in a different way. That has not happened.

Chairman **Annunzio**. Mr. Gonzalez.

Mr. **Gonzalez**. Thank you, Mr. Chairman.

I also wish to thank the two distinguished colleagues from New York, and once again I compliment them for their initiative and leadership and want to thank the lady member of the Federal Reserve Board for being with us this morning.

Mr. Schumer, when you said you drafted your bill, you hoped it wouldn't be approved.

I can see why. You are asking the biggest loan shark in the world to conduct a study on the credit junkies. I can tell you right away, hope springs eternal in a youthful heart.

Mr. SCHUMER. If I may, the study does not give the Federal Reserve Board discretion to make policy decisions on this issue. I have asked them to look at two things: Competition within the market and whether the rates follow the cost of money. I hope this bill will be approved. If the bill is approved, I would wager that during the course of the study you are not going to find issuers 1 through 10 lining up at 19.5 and above.

The cap may not have to go into effect if the Federal Reserve finds that rates meet the narrow restrictions of the study. I have faith that the Federal Reserve will do a fair study but I wouldn't ask them to make the policy decision. They shouldn't be determining whether the Congress or the Federal Government should set ceilings. They are, in my opinion, the best agency to do an objective and fair study about whether there is competition and whether the cost of credit card funds follows the cost of money.

Mr. GONZALEZ. Then you were optimistic because that is what the Federal Reserve Board has been doing, it has been making policy.

Mr. SCHUMER. My bill does not let them make policy in this situation.

Mr. GONZALEZ. Whether we like it or not, I had two different Chairmen of the Federal Reserve Board come right where you are and say that in effect, was what they intended and meant to do. So I really—frankly, I would be very much against your bill, even though it is a study, you still in the other section place other responsibilities.

And my dear friend, Mr. Biaggi, let me say I will probably go along with yours. If it was good enough for the chairman, it ought to be good enough for me, and if it will fly in Little Rock, as I have been telling my colleague to the right, I don't see why it won't fly in Macon, GA. I just don't see it. But then I really feel that perhaps this is too little too late, and it is just a little nibble at what the real fundamental problem is.

When I came up to the Congress about 24½ years ago I left the State senate where I had filibustered one of my last actions, and it was a baby filibuster, all I had to do was take the floor for about 11 hours, and I killed the attempt then to get around the usury laws in the name of the small lender, those that would be lending $100 or less, or $200 or $300, and they wanted to rationalize on the same argument basis that we hear here.

Well, we were able to stop it. But I hadn't been sworn into the Congress one week before—well, a session of the legislature in Texas on an emergency basis passed a bill out and legitimatzed up to 362 percent interest on small loans. So I left what we started calling the loan shark State, instead of loan star State, and came up here, and what do I see? I see the tracks of that beast coming all the way up here, and got excited about it.

When I see the Wright Patman Credit Union in the Rayburn Building is charging 16 percent, I just wonder how many times old Wright Patman has turned over in his grave. Because I am still an admiring and approving member of Wright Patman's lost battle.

Ms. Seger, you referred to the rather unfortunate experience with the 1980 so-called credit controls. The Federal Reserve Board didn't want them, Congress imposed them. The way they went about it was calculated to do the whole business in. I think you will grant me that. I recall vividly the experience because I kept pointing out credit controls, of course, can work, they did work for Harry Truman, they worked for Franklin Roosevelt.

At the height of World War II, over 46 percent of the national gross product was being used on the Federal level. The debt per capita, and any other wage percentagewise was as great as ever. Yet, through credit controls and other means, the Government never had to pay even 3-percent interest charges.

Now, that didn't happen because of the holy spirit, that happened because both the President, two Presidents, and a Congress didn't sell out the greatest overwhelming interest of the American people to the bankers who finance. They did try, but they bumped into a Secretary of the Treasury that resisted and was able to do so very skillfully. We haven't been that lucky since then.

So I think it is a foregone conclusion that whether you predicate it, Mr. Biaggi, on the Fed rate or not, it is the will of the wisp. It is like saying you can go to the market, it is like telling a drug junkie that he is going to go to the open market of the pusher. There is no difference. The only thing, one is drugs, this is credit, and we do have a nation of credit junkies, whether it is a credit card or anything else.

You talk about car rate loans, Mr. Schumer, let me tell you, yes, you might get 9 or 10 percent somewhere, but you look up at the cash payment that is required now at that rate, and you will see the difference. So you still have the country victimized by high rates of interest, and somewhere at sometime they are going to have to be controlled. No nation in the history of mankind has ever succeeded as a nation without controlling interest rates.

Thank you.

Chairman ANNUNZIO. Thank you, Mr. Gonzalez.

Mr. Ridge.

Mr. RIDGE. Thank you.

You mentioned in your testimony that if the Fed determines the rates reflect the cost of funds to creditors and competition among creditors for new accounts, then no cap would be imposed. You set up the guidelines to take into consideration those two concerns that you have.

With regard to determining that the interest rates reflect the cost of funds to creditors, may I assume that in the study you would compare, using the discount rate, the cost of funds?

Mr. SCHUMER. The 3-month Treasury bill. One of the things about which I agree with my colleague on my right is that we ought not use the discount rate, but we ought to use a market rate.

Mr. RIDGE. I assume the 3-month T-bill rate plus will allow for the cost of administration of the credit card program, and an acceptable rate of return.

Mr. SCHUMER. Yes.

Mr. RIDGE. I guess what I am trying to get at is the T-bill will be known, and we can probably compute the cost of the administration, but if the rate of return is in excess of what you believe it should be, it is that rate of return or the profit margin that you are going to reduce. And for someone who believes as you do, and I believe you felt that the marketplace can best allocate resources, do we not set a dangerous precedent, whether looking at the banking industry or the general retail industry or the automotive industry, when we set out to find or promote a policy that limits a profit margin on any industry in this country?

Mr. SCHUMER. I would agree with the gentleman from Pennsylvania if there were competition. It seems to me as someone looking from the outside in, but who has looked very carefully, that there isn't any competition.

Look at that chart. That is the greatest indictment of the supposed free market in the credit card industry. There is no price competition. Issuers compete only by thinking up clever ads or slogans.

When is somebody going to compete by making it cheaper to borrow money on these credit cards? Of 200 major issuers of cards, not one dared go below the threshold. The cost of money, the most variable cost, has dropped but rates have not.

If fraud had greatly gone up, which it has not, if administrative costs had skyrocketed, which they have not, then there might be some justification, for a 3-percent spread to become a 9- or 10-percent spread at different times. However, that is not what is happening.

The real problem with our free market is it is not very free.

Mr. RIDGE. Have you not concluded by the way you have structured the study already and the fact there are 200 card issuers with a small variance in rates that indeed there is no competition.

It seems the way you structured the study, if the criterion for competition is a variance in rates, then you concluded that there is no competition. In fact, in a perfectly competitive market, there would be no variance in rates, would there? If it is perfect competition, it is the ideal model.

Mr. SCHUMER. In a perfectly competitive market, there wouldn't be 300-percent increases in profits when there are 200 users ready to compete. In a perfect market, the profit margin would be extremely small because everybody would be lowering their rates to compete for consumers.

This is not a model of the free market working when all those rates are so high and profit margins keep going higher and higher.

Mr. RIDGE. Your definition of competition has nothing to do with number of companies in the marketplace. Your definition of competition would be a dramatic or substantial difference in rates.

Unless that appears, you conclude that there is no competition.

Mr. SCHUMER. I have asked the Fed to determine two things: if rates reflect cost of money and if there is competition within the industry. I would not find very satisfactory an answer from the Federal Reserve that there is plenty of competition, because issuers are all sending out lots of cards to everybody. You don't want the same type of behavior among all the companies.

Mr. **Hiler**. We are espousing some new economics here that I have to say—I am not sure what side it is. I always thought the presence of—you are defining competition in a way totally unlike anyone who ever wrote antitrust laws had in mind, or anyone who wrote economic books had in mind, or any way the market has ever operated.

To say you can only have competition if there is a difference in prices and if people sell their products differently——

Mr. **Schumer**. That is not what I am saying.

What I am saying is that there are 200 major issuers, all of whom are exhibiting the same behavior. Adam Smith would turn over in his grave if you called that competition. It is not competition. You know it and I know it.

Mr. **Ridge**. Could I ask Ms. Seger to respond as well?

Ms. **Seger**. I am going to respond not as a lawyer, but as a former economics professor.

Mr. **Schumer**. I don't know who has gotten us in more trouble in this country, economic professors or lawyers.

Ms. **Seger**. We are vying for first place.

But nonetheless, in the textbooks, in the perfectly competitive model, there is a homogenous product and a single price set by market forces. There are many market participants, none of whom can in fact move the price. They are all price takers. However, as I have indicated, much of the stability of credit card finance rates reflects controls on credit card rates that have been enacted in many States.

Mr. **Schumer**. It is my understanding that profits have gone up to very high levels in the last few years and that is not what the model of the free market postulates at all.

According to the model, high profits would bring the rates down. Instead of making the 200-percent profit as Chase Manhattan did, issuers would rather be saying, OK, we will reduce the rate to 17 percent to stay in business.

Ms. **Seger**. The market restraint on profits comes from free entry. If profits are highly attractive, there will be a lot of additional entrants into the market.

There have been a lot of new issuers—a lot of small credit unions, savings and loans, and retailers—and I am sure the total is way over 200.

So, there has been free entry. Lots of people have come in. My own credit union back in Michigan, which was the Michigan State University Employees Credit Union, issues credit cards and 17 percent is the rate. It is below the rate I pay Citibank-VISA.

Chairman **Annunzio**. Mr. Barnard.

Mr. **Barnard**. Thank you, Mr. Chairman.

First of all, let me commend you as chairman of this committee for having this hearing. I think it is going to prove to be very beneficial not only to the Members of Congress but also to the general public.

The subject of this hearing this morning commanded a very prominent part of a news program this morning, which indicates the interest of the general public in this subject, so I think this can be very educational, mainly because the fact is the general public should know, as well as Members of Congress, what the credit card program in America really is.

Ms. Seger, what is the difference between a credit card operation and a regular consumer loan? The fact is, doesn't the credit card system today enter into the payment system of this country as much as the clearing of checks?

Ms. **Seger**. First of all, when you look at credit extended by a credit card——

Mr. **Barnard**. I can't hear you.

Ms. **Seger**. When you look at the credit extended by a credit card and compare that to a normal consumer loan, there is far more convenience. It is preapproved up to a certain dollar limit, and the individual who has the card, can use it when and as he or she chooses. But the key decision is made when the credit card is issued and the credit limit is established.

Now, the situation differs if you are talking about a regular consumer loan. In fact, before they had credit cards, for example, if I wanted to go to Europe and needed $1,000 for that trip, then I would have to go to the lender to fill out a credit application for that specific $1,000. Six months later, if I wanted $800 to buy a color TV the entire process would have to be repeated.

Mr. **Barnard**. That is—I think that is well understood.

The point I am making is, hasn't the credit card program itself, by banks, merchandise houses or otherwise, hasn't it become a part of the payment system of the country?

Ms. **Seger**. Yes, because many individuals now use a piece of plastic to make the purchase whereas, in prior days, they would have used cash or would have written a check.

Mr. **Barnard**. Does the Fed have any information as to what the outstanding balance of a credit card is as compared to a consumer loan?

Ms. **Seger**. In August, total revolving credit outstanding was $108 billion.

Mr. **Barnard**. Is that credit cards?

Ms. **Seger**. That is the total of so-called revolving credit at commercial banks, retailers, and gasoline companies.

Mr. **Barnard**. $108 billion?

Ms. **Seger**. Yes.

Mr. **Barnard**. You don't know what that is on a per capita basis, do you, what the average credit card loan would be? I mean, is it $500, $600, $400?

Ms. **Seger**. I don't have that information.

Mr. **Barnard**. It is $532.

The question I am asking is, is it more expensive to make a loan for $532 than it is for $8,000, $5,000?

Ms. **Seger**. There are some fixed costs involved in processing a credit application and extending the credit. Obviously, if you are spreading that fixed cost over a larger loan, then the cost per dollar loaned is less. And this is also true in commercial lending, that big commercial loans have a lower per dollar fixed cost than a loan to the corner dry cleaners or to a typical consumer.

Mr. **Barnard**. I am sure that my distinguished colleague and friend and Member of the Banking Committee will be astounded to hear that I think that your study is most worthy, I really do. I think the Fed would do well to make a study, because I think that we generally need to know more about the credit charges.

I think there is an abysmal lack of understanding. I think these charts really somehow don't tell the full story. I think if we would find the full story, I think the people would find out—I don't know what these rates are, what the market should bear.

I don't know that those are the rates. I am not saying that is what the rates should be, but I think that at some point in time the card carrier needs to know the value of what he has got in that plastic card.

In your consideration of the rates, have you thought about including in that not only credit cards but regular installment loans to arbitrarily reduce those to some set figure?

Mr. **Schumer**. First of all, I appreciate the support of my colleague. We have searched for 5 years for something——

Mr. **Barnard**. This is just one paragraph of the bill, now, six lines. Don't swallow the whole thing.

Mr. **Schumer**. A trip of 1,000 miles starts with the first step.

Mr. **Barnard**. Six lines.

Mr. **Schumer**. These are the first six lines we have agreed on in 5 years.

In any case, personal loans are a good analogy; they are unsecured and therefore resemble credit cards. The cost to consumers of personal loans has gone down as the cost of money has gone down. Not as much as a car loan or a mortgage because there is nothing secured. However the cost of an unsecured personal loan has dropped.

Mr. **Barnard**. What are you basing that on? The interest on automobile loans has gone down and that is understandable. They are trying to sell American cars. But what about just regular installment credit?

Mr. **Schumer**. The rates are here on this chart. It is the green versus the red line.

Mr. **Barnard**. Let me ask you this question. That is not much of a drop.

Mr. **Schumer**. They have declined, however. And the interesting thing about the green line is that it has some relation to the cost of money, even though it is not as steep and not as varied when interest rates were lower, in February 1980, personal loans were 15 percent. When the cost of money went up in May personal loans were 15 percent. When the cost of money went up in May, personal loans went up to 20 percent. There is no similar variation with credit cards.

Mr. **Barnard**. You don't have the same convenience in an installment loan you do in a credit card. If you look at that chart, the rate on credit cards remains pretty constant.

At one time, it was lower than the installment—in fact, at one place it was lower than the prime rate. I think that—you see, what I am saying is, I think a study would be helpful, because I really believe we will find in the long run, when we consider the fact that in a credit card operation—here is a typical example.

In a credit card operation, there are as many as 22 different steps from the time that you apply for a credit card and the time you use a credit card. The fact is, from the time you get a credit card, there are 10 steps, 10 different operations requiring people, requiring handling, requiring return items like in a check.

So I think a study would be good to bring out to the public and to us, the fact is that maybe we don't have as excessive charges as may appear, considering the service you are getting. Another thing about it——

Mr. SCHUMER. The answer is that credit card services have been constant. In other words, unless it could be documented otherwise—and the study might show it—the basic cost of issuing a credit card, of going through those 10 steps, has risen at a small rate but has not risen very much. At the same time the cost of money has gone way down, but rates have risen.

As to your other point about personal loans, I agree they are different items from credit cards. On the one hand, on a personal loan the bank has immediate control. It knows what the loan is for and the loan is a one-time shot.

On the other hand, credit card issuers only have to do a single credit check of the individual and every time there is a loan outstanding, the issuers get their rate of return. Thus, there are tradeoffs.

I am glad the gentleman agrees study is needed.

Chairman ANNUNZIO. The Chair is going to enforce the 5 minute rule.

Mr. BARNARD. Did I take up more than my 5 minutes, Mr. Chairman?

Chairman ANNUNZIO. We have another panel, and we have Mr. Roth.

Mr. ROTH. Yes. Being I was one of the first members here, I think I will take my 5 minutes.

I have a question of Ms. Seger. I think you made some good points and I was impressed by your statement, but there is one area where you said instead of offering lower finance rates, competitors may choose to compete by easing credit standards.

What you are saying is, we are going to keep interest rates high for the responsible users but lower the standard so we can get more cards out to the general public. I think it is poor policy.

You are making the responsible people pay for the ne'er-do-wells. That is one of the problems we have had in this country for eons.

Ms. SEGER. I am just saying that I think some lenders are choosing to compete by nonrate means, and that rather than dropping the rates they are easing the credit standards and, as you say, this broadens the base, and brings more people in. In many cases this represents a return to more normal credit standards following a perod in which such standards had been tightened.

Mr. BIAGGI. Will the gentleman yield?

Mr. ROTH. Yes, in just 1 second.

It seems to me this is part of your statement, part of your rationale for your stand, and I am just saying I think this is poor public policy. This is the type of thing we should be discouraging, not encouraging. Why should a responsible person have to pay for the person who doesn't pay his or her bills?

I would be happy to yield to Mr. Biaggi.

Mr. BIAGGI. I thank the gentleman for yielding.

I think you struck the nub of the problem. The issuers of these loans want to reach out to the entire market. This preapproved credit card mailing approach is a dragnet to bring people in who shouldn't have any credit, many of whom shouldn't have credit. That is where you have your major problem.

I think if there was elimination of that preapproved credit card mailing policy, there would be a diminution of cost, a diminution of losses associated with this poor business pratice.

I think the gentleman is right on target as far as the issuers are concerned. They are luring more customers in, but are keeping interest rates inflated to makeup for the losses associated with this poor business practice.

Mr. Roth. I have one question for Mr. Schumer, and that is, you always point to this chart saying you know we have all these people charging approximately the same interest rates. Couldn't the argument be made that is what it takes to be profitable in this business?

Mr. Schumer. One could make that argument, but if I believed it, I wouldn't have introduced the bill.

First, some people seem to be able to make a profit with less, as Manufacturers Hanover just dropped their rate.

Second, profitability has gone way up over the last few years. The profit margin is not right at the edge. The margin is very, very large.

Mr. Roth. Have you stated some cases where credit card companies have lost money?

Mr. Schumer. Yes; I have. But I have not seen cases where issuers can't make enough on the interest rate.

Here is the chart of credit card earnings, and as you can see they have increased considerably over the last year.

I would venture to say they have gone up even higher in previous years, since the cost of money has declined even more sharply in previous years.

One of the reasons issuers are sending out all these prepaid credit cards is that it is so lucrative to get new accounts at 18, 19, and 20 percent. If this is competition, it is backwards.

You made a very good point, one that I agree with completely. Why shouldn't there be a number of credit card users that don't reach out and send cards to everybody? These issuers could be very tight with the availability of credit. They are not going to issue cards to everybody but would instead charge a lower rate of interest.

Mr. Roth. I just want to make this one comment. I know my time is almost up. And that is, I think what you are saying, Mr. Schumer, is welcome news to us in this respect, that your entire argument is based on: the interest rates have come down, therefore these interest rates on credit cards should come down too.

Mr. Schumer. Or there ought to be a good explanation by some independent authority why they haven't.

Mr. Roth. The point is, the reason interest rates have come down since 1980 is because of supply-side economics and we at supply side want to thank you for making this case for us. Thank you very much.

Mr. Schumer. If I can agree with Mr. Barnard on a paragraph, I am sure we can agree on the comedy and comity of your comment.

Chairman Annunzio. Mr. Wylie.

Mr. Wylie. Thank you, Mr. Chairman.

Mr. Chairman, I know time is limited. I just have one question of Ms. Seger.

We have more or less honed in on the banks here this morning as far as the testimony is concerned, but there are other industries which are involved in the credit card field, the retail industry, for instance, and some corporations have credit cards; the automobile industry uses credit cards.

How do recent profits compare in the bank credit card industry with the profits of credit cards in other industries? Do you have any statistics on that?

Ms. Seger. I don't have that information. In fact, I have some questions about the numbers that were just shown. I don't think that those are profits on bank credit cards. They appear to be the third quarter earnings reports for those large banks as a whole, and that is a far cry from what they are earning on credit cards.

Furthermore, it is just the percent change in earnings from 1 year to the next, which is hardly a measure of profitability.

Mr. Wylie. I think if we are going to look at the issue of credit cards here, we need to look at credit cards as far as all industries are concerned. And if you could supply for the record some information along the lines that I have asked, I would appreciate it.

Ms. Seger. I can tell you that the rate ceilings differ in particular States for retailer credit card plans and so-called bank credit cards. For example, in Michigan the ceiling for bank credit cards is 18 percent per year whereas the ceiling rate for a retailer who offers a credit card is 20.4 percent. The law makes that distinction because individual institutions do have different sources of funds as well as other costs that may differ.

Dayton Hudson cannot borrow at the discount window at 7.5 percent. In fact, at one time they were paying prime plus, so they were having to raise money at a cost that exceeded what they could charge on their credit cards. It is a far more complicated situation than some of these charts are showing.

Mr. Wylie. Thank you.

I have a couple other questions I would like to supply for the record.

Chairman Annunzio. All right.

[Ms. Seger subsequently supplied the following information for the record:]

With reference to how recent profits in the bank credit card industry compare to profits in the credit card operations of other industries, such as retailers or oil companies, such data are not available at the Federal Reserve.

Chairman Annunzio. I want to thank the members of my first panel for their contributions this morning and your patience.

Will the members of the second panel come forward?

Will the panel take their places. We are running under a time constraint. The House goes into session at 12 p.m., so we are going to attempt to finish the hearing with this panel. If there are any calls on the floor of the House, the panel will be patient and wait while we go out and vote and come back.

I want to remind the members of the panel that if you have a prepared statement, your entire statement will be made part of the record, and you will all have 10 minutes for presentation.

Our first witness this morning is Hon. Franz S. Leichter, State senator from the State of New York. Senator Leichter, I welcome you before the subcommittee. It is good to have you here. Proceed for 10 minutes in your own manner.

STATEMENT OF HON. FRANZ S. LEICHTER, STATE SENATOR FROM THE STATE OF NEW YORK

Mr. **Leichter.** Thank you very much, Mr. Chairman.

I want to thank you very much for inviting me to appear before this distinguished subcommittee, particularly on an issue of national importance. I am particularly pleased, Mr. Chairman, to have an opportunity to share some thoughts with you in view of your national reputation as a courageous champion of the consumers of this country, especially banking consumers.

I have come down here, Mr. Chairman, to express my support in principle for the two bills that you heard testimony on earlier today, H.R. 1197 and H.R. 3408, and I am proud these have been presented by distinguished members of the New York delegation, my home State.

Walter Wriston said, when he was the chairman of Citicorp, "once you let the genie of high interest rates out of the bottle, it is very tough to put it back in." Mr. Chairman, I think only legislation will do it. I agree with you on the need to educate the consumer, because as you point out, in some respects, we all have become addicts to that plastic, but the fact also is, Mr. Chairman, that it is very difficult to function in this society without a credit card.

I came down here today on the shuttle, and I am going to stay in Washington, but it is going to be very difficult for me to carry the amount of cash needed to pay all my bills. I come from a community—and there are many such communities throughout our country—where you don't feel safe carrying a great deal of cash. The fact is you really do need access to credit cards and that much as my populist heart beats fast when you say "Let's all cut up our credit cards," I am afraid I am going to need mine today, Mr. Chairman.

But as has been pointed out, I think billions of dollars in unjustified profits have been paid in interest charges on credit cards. And while there may be no reason why the rates are excessive other than the ability of the banks to make these great profits, there certainly is an explanation, which is that the banks are covering their losses on unwise and very large foreign loans and on some of their unwise commercial loans.

The fact is—and it is no secret and it has been documented and it is right in the records of the banks—that they are making a great deal of money on consumer lending, particularly on credit cards. Lawrence Cohn, senior banking analyst at Dean Witter & Reynolds, was quoted in the American Banker in January 1984, saying:

> Banks with credit card operations are making a lot of money. They were making it in January, 1984, and they are making even more money today.

The recent earnings reports that Congressman Biaggi referred to are due in great part to the moneys being made on consumer banking. Now I don't think any of us here have any objection, as such, to banks making money. I think we are all happy when any part of the American economy is showing a good return. But I think there comes a point when we have to look at the impact on the consumer and the impact on the economy as a whole.

Let me just share with you very briefly the New York experience. In 1980, New York State was one of those States which regulated interest rates, and we did so with a very heavy hand. We were very inflexible. Our interest rate at that point was limited to 12.0 percent for the first $500 of outstanding balance. That clearly was unreasonable. And the bankers came to us and said:

> Listen, we are going to withdraw our credit card operations from New York State. We are not going to make credit available to New Yorkers unless you lift those limitations.
>
> And we tell you this, that if you lift the limitations and national interest rates are high, then the interest rates in New York State are going to be high, because they are going to reflect the cost of money. But when the interest rates go down nationally, they are going to be down for the New York consumer.

And Congressman Schumer, who was then a member of the State legislature, I am sure, remembers those very convincing arguments. Whether it was my stubbornness, or whatever, I voted against deregulation because I was a bit suspicious. But we did deregulate and the interest rates right away went up, and the interest rates have stayed up.

And after a year, we said, 2 years, when the interest rates began to——

Chairman ANNUNZIO. Senator, do you have a cap in New York?

Mr. LEICHTER. We have no cap now. Well, 25 percent is criminal usury, but the deregulation, I would say for all practical purposes, was fairly complete.

And the interest rates, as I say, went up and after 2 years, as national rates began to decline, we went to the banks and said, "Hey, how about the consumer? When are we going to see those rates go down?" They said, "Look, we have to look at it a little longer, this may be temporary, so speak to us next year." We did that and got the same answer, and by and large, we have been getting the same answer to the present day.

I have introduced legislation in New York to impose a cap, not the heavyhanded cap we had before, but a flexible one similar to the approach of Congressman Biaggi and Congressman Schumer. I think there is justification for that, and I think that we know enough about how credit card operations work, we know what the profits of the banks are, that with all due respect to Congressman Schumer, I don't believe any study is necessary. I think that right now, if we take a look at the spread between the cost of money and the interest rates that are being charged, it is at historically high levels. It is almost 11 percent.

Traditionally the banks have done very well with a 6-point spread. We know what the cost of credit card operations are generally—and this is an analysis that comes from the American

Banker, that what the banks need is 5 points above their cost of money to make a profit on credit cards; 300 basis points are needed to cover operating expenses and another 200 to cover losses and fraud costs.

Now, in addition to this spread that we have, of course, most credit cards now have an annual membership fee. In addition, of course, there is also the merchants' charges. So there is no question but that the level of interest rates is unreasonable, that profits are excessive and that the consumer is entitled to protection.

Now I appreciate that we have to be wary any time we interfere with the free market, but I think the point is the free market has not worked in this area. I think Congressman Gonzalez stated what is a historical truth, that societies have traditionally regulated the cost of money. They have regulated interest rates. And this country has had some of its greatest periods of prosperity at a time when interest rates were regulated. So I believe that if the argument of deregulation and the need to let the economy express itself is made, then history really favors a regulation of interest rates.

I just want to finally say, Mr. Chairman, and members of the subcommittee that I really believe we would be best served by national action. Individual States can act—Arkansas apparently has. And by the way, I am advising New Yorkers—I put out a brochure for my constituents—to "Go get your credit card from Arkansas." We called a banker in Little Rock who offered very low rates and he was delighted and said "Fine, come on down." Many of my constituents are doing that.

The point is that to have the individual States act is going to be difficult, it is not going to be in the national interest, and it is not going to be very effective for the individual States because, obviously, banks have a mobility nowadays that they might not have had some years ago. They might move out of that State.

Such regulation, then, would be of limited effect. I think the national approach is the correct approach. I think you have it in your power to put that genie of high interest into the bottle.

Thank you very much, Mr. Chairman.

[The prepared statement of Hon. Franz S. Leichter follows:]

STATEMENT OF NEW YORK STATE SENATOR FRANZ S. LEICHTER (D-L, MANHATTAN) BEFORE THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS, SUBCOMMITTEE ON CONSUMER AFFAIRS AND COINAGE, REGARDING PROPOSED LEGISLATION TO REGULATE CREDIT CARD FINANCE CHARGES

I APPRECIATE THIS OPPORTUNITY TO APPEAR BEFORE THE SUBCOMMITTEE TO EXPLAIN THE COMPELLING REASONS WHY I STRONGLY SUPPORT THE INTENT OF THE TWO PROPOSED BILLS.

AN ARTICLE ON THE FRONT PAGE OF THE BUSINESS SECTION OF LAST WEDNESDAY'S *NEW YORK TIMES* WAS HEADLINED, "BIG BANKS BASKING IN PROFITS". THE ARTICLE STATED THAT, DESPITE PROBLEMS WITH FOREIGN AND DOMESTIC COMMERCIAL LOANS, "IN CONTRAST TO GENERALLY LACKLUSTER EARNINGS THROUGHOUT MOST OF CORPORATE AMERICA, MOST OF THE LARGER COMMERCIAL BANKS MANAGED TO SPORT EARNINGS GAINS THAT WERE WELL INTO THE DOUBLE DIGITS". FURTHER ON, THE ARTICLE RELATED THAT MUCH OF THE REASON FOR THIS EXCEPTIONAL PERFORMANCE WAS A FAILURE OF CONSUMER LENDING RATES TO DECLINE, DESPITE A DROP IN THE INTEREST DEPOSITORS EARN ON THEIR ACCOUNTS.

CLEARLY, BANKS ARE ENJOYING AN ENORMOUS, RECORD SPREAD BETWEEN THEIR COST OF FUNDS AND THE RATES THEY CHARGE WHEN THEY LEND THESE FUNDS TO THE CONSUMER. THIS IS PARTICULARLY TRUE IN THE CREDIT CARD BUSINESS, WITH THE CONSQUEQUENCE THAT THE 70% OF CREDIT CARD USERS WHO DO NOT PAY OFF THEIR ENTIRE BALANCE EVERY MONTH ARE BEING GOUGED. THE 19.8% INTEREST RATE BEING CHARGED BY CITIBANK, CHASE MANHATTAN, AND OTHER MAJOR ISSUERS IS INEXCUSABLE AT A TIME WHEN THE PRIME RATE IS 9.5%, THE FEDERAL FUNDS RATE IS 8.05%, THE DISCOUNT RATE IS 7.5% AND THREE-MONTH TREASURY BILLS ARE AT 7.25%. THE TOTAL COST OF MONEY TO THE BANKS, ACCORDING TO THE EXPERTS I HAVE SPOKEN WITH, IS NOW ABOUT 8% TO 8.5%. THAT RESULTS IN AN 11 POINT SPREAD WHEN MONEY IS LENT OUT AT 19.8%. TRADITIONALLY, THE CREDIT CARD SPREAD HAS BEEN 6 POINTS OR LESS.

I FIRST BECAME INVOLVED IN THIS ISSUE OF CONSUMER LENDING

RATES BACK IN 1980, WHEN NEW YORK FOLLOWED MOST OTHER STATES IN TOTALLY DE-REGULATING CONSUMER BORROWING RATES AND ALLOWING CREDIT CARD ISSUERS TO ALSO CHARGE AN ANNUAL MEMBERSHIP FEE. I VOTED AGAINST DE-REGULATION, NOT BECAUSE I DIDN'T THINK THE BANKING INDUSTRY DESERVED SOME RELIEF FROM THE INTEREST-RATE SQUEEZE THEN HURTING THEM, BUT BECAUSE DE-REGULATION WAS TOTAL: NO CEILINGS WERE PLACED ON THE RATES AND THERE WAS NO REQUIREMENT THAT WHEN THE COST OF MONEY DROPPED, THE CONSUMER LENDING RATE WOULD ALSO DROP. I POINTED OUT THAT IN THE CREDIT CARD BUSINESS IN PARTICULAR, THERE IS LITTLE ACTUAL COMPETITION. ONCE A CUSTOMER HAS SIGNED UP WITH ONE ISSUER, IT'S NOT SUCH AN EASY MATTER TO TEAR UP THE CARD AND THEN APPLY TO ANOTHER ISSUER WHENEVER A RATE GOES UP. MOREOVER, IT IS RARE FOR AN ISSUER TO BREAK RANKS AND OFFER A SUBSTANTIALLY LOWER RATE.

I THINK THAT FOUR YEARS OF EXPERIENCE WITH RATE DE-REGULATION IN NEW YORK SHOWED I WAS RIGHT. CONSUMER LENDING RATES SKYROCKETED IMMEDIATELY AFTER THE DE-REGULATION LAW TOOK EFFECT, WITH CREDIT CARD RATES IN NEW YORK JUMPING FROM THE LEGAL MAXIMUM OF 12% ON THE FIRST $500 AND 18% ON THE REMAINING OUTSTANDING BALANCE TO 19%, 20% AND EVEN 21% ON THE WHOLE OUTSTANDING BALANCE. MY STAFF BEGAN PERFORMING OUR PERIODIC SURVEYS OF CONSUMER LENDING RATES AND, BEGINNING IN LATE 1982 AND EARLY 1983, WE NOTICED THAT WHILE NATIONAL INTEREST RATE INDICATORS WERE ALL DECLINING, CONSUMER LENDING RATES --PARTICULARLY CREDIT CARD RATES-- WERE STAYING AT THEIR RECORD LEVELS.

INDUSTRY SPOKESPERSONS SAID THAT IT WOULD TAKE TIME FOR THE RATES TO DROP, THAT THERE WAS A LOT OF "CATCHING UP" FOR THEM TO DO. BUT THE RATES STILL HAVEN'T DROPPED DESPITE A CONTINUED DECLINE IN ALL OTHER INTEREST RATES. INDEED, MY SURVEYS FOUND THAT THE AVERAGE CREDIT CARD RATE IN NEW YORK ROSE FROM 18.7% TO 19.2% FROM JANUARY, 1984 TO JANUARY, 1985.

MANUFACTURER HANOVER'S RECENT ACTION DROPPING THEIR CREDIT CARD RATE FROM 19.8% TO 17.8% WAS THEREFORE LONG OVERDUE. BUT WILL THE OTHER ISSUERS FOLLOW THIS LEAD? I THINK THEY ARE WAITING TO SEE IF CREDIT CARD HOLDERS START SWITCHING TO MANUFACTURERS

AND THAT THEY'LL KEEP THEIR RATES AT 19.8% A WHILE LONGER. THE DECLINE TO 17.8% MAY NOT BE SUFFICIENT TO PROMPT HOLDERS TO GO THROUGH THE INCONVENIENCE OF SWITCHING. A DECLINE TO AROUND 15%, I THINK, WOULD GET MILLIONS OF CARD HOLDERS TO SWITCH.

MOREOVER, THE DECLINE TO 17.8% IS ONLY HALF A STEP. I HAVE DONE SOME ANALYSIS OF CREDIT CARD ISSUERS' COSTS SHOWING THAT, AT LEAST ~~IN~~ NEW YORK, 15% INTEREST RATES WOULD STILL PROVIDE A DECENT PROFIT. WITH ASSISTANCE FROM THE FED'S FUNCTIONAL COST ANALYSIS, ANALYTICAL ARTICLES IN AMERICAN BANKER AND ELSEWHERE, I DETERMINED THAT BANKS AT THE UTMOST NEED FIVE POINTS ABOVE THEIR COST OF MONEY TO MAKE A PROFIT ON CREDIT CARDS: THREE HUNDRED BASIS POINTS ARE NEEDED TO COVER OPERATING EXPENSES AND ANOTHER TWO HUNDRED POINTS ARE NEEDED TO COVER LOSSES AND FRAUD COSTS. THAT WOULD PUT THE CURRENTLY REQUIRED RATE AT ABOUT 13.5% TO 14.5% FOR A GOOD PROFIT TO BE MADE.

OF COURSE, THIS ANALYSIS DOES NOT INCLUDE THE OTHER INCOME ISSUERS GET: ANNUAL MEMBERSHIP FEES OF $20 PER CARD (A NUMBER OF BANKS HAVE PVER A MILLION CARDS OUTSTANDING) AND THE PEES PARTICIPATING MERCHANTS MUST PAY, AMOUNTING TO AT LEAST 2% OF THE COST OF MERCHANDISE SOLD. WITH VARIOUS KINDS OF "PREFERRED" AND "GOLD" CARDS CARRYING ANNUAL MEMBERSHIP FEES OF $35 TO $60 NOW BEING PEDDLED (THE BANKS' COSTS ARE NOT MUCH HIGHER THAN WITH REGULAR CARDS) INCOME RISES STILL FURTHER. NO WONDER LAWRENCE COHN, SENIOR BANKING ANALYST AT DEAN WITTER REYNOLDS WAS QUOTED IN AMERICAN BANKER BACK IN JANUARY, 1984 AS SAYING: "'BANKS WITH CREDIT CARD OPERATIONS ARE MAKING A LOT OF MONEY'". THEY'RE MAKING EVEN MORE TODAY.

EARLIER THIS YEAR I WROTE TO THE HEADS OF CITIBANK, CHASE MANHATTAN, AND CHEMICAL BANKS SEEKING AN EXPLANATION OF THEIR 19.8% INTEREST RATE ON CREDIT CARDS. ONLY CHASE GAVE ME A REPLY. CHASE SAID THAT THEY NEEDED A 19% RATE TO BREAK EVEN, BASED ON AN 11% COST OF MONEY, A NEED FOR 300 BASIS POINTS FOR LOSSES, AND 500 BASIS POINTS FOR OPERATING COSTS. YET AT THE TIME OF CHASE'S REPLY, BANKING INDUSTRY EXPERTS TOLD ME THAT THE COST OF MONEY WAS REALLY ONLY 9% --ALREADY SHAVING TWO PERCENTAGE

POINTS OFF THEIR BREAK EVEN REQUIREMENT. OF COURSE, CHASE NEGLECTED TO MENTION THE ENORMOUS INCOME THEY GET FROM THE ANNUAL $20 MEMBERSHIP FEE AND THE MERCHANT FEES. AND THEIR LOSS REQUIREMENT WAS AT LEAST 100 BASIS POINTS TOO HIGH.

I HAVE INTRODUCED LEGISLATION IN THE NEW YORK STATE SENATE WITH AN INTENT VERY CLOSE TO THE BILLS BEING DISCUSSED AT THIS HEARING. MY BILL WOULD SET THE TOP RATE AT SEVEN POINTS ABOVE THE RATE FOR THREE-MONTH TREASURY BILLS. THE CEILING WOULD BE ADJUSTED QUARTERLY. FOR RETAILERS THE MAXIMUM WOULD BE EIGHT POINTS ABOVE THE TREASURY BILLS. THEREFORE, THE CEILING WOULD CURRENTLY BE SET AT ABOUT 14.5% FOR BANKS AND 15.5% FOR RETAILERS.

THE LEGISLATION NOW BEFORE THE SUB-COMMITTEE WOULD SET A TOP RATE OF ABOUT 12.5% TO 13%. TO BE FAIR, I THINK SUCH A CEILING WOULD BE A POINT OR SO TOO LOW. I DO NOT THINK WE WANT TO SET UP THE SITUATION WHERE ONLY THE MOST WEALTHY, BLUE-CHIP INDIVIDUALS COULD GET CREDIT CARDS. SO I RECOMMEND ADDING A POINT OR A POINT-AND-A-HALF.

NATIONAL CREDIT CARD INTEREST RATE CEILINGS ARE MUCH MORE DESIRABLE THAN STATE ONES. BANKS HAVE ISSUED VEILED THREATS THAT THEY WOULD MOVE THEIR CREDIT CARD OPERATIONS OUT OF NEW YORK STATE IF MY BILL WERE TO BECOME LAW (ALTHOUGH I THINK THAT WOULD PUT THOSE BANKS THAT MOVED AT A SIGNIFICANT COMPETITIVE DISADVANTAGE TO THE BANKS THAT REMAINED AND, WERE CHARGING LESS THAN 15%). NATIONAL LEGISLATION WOULD PREVENT BANKS FROM PLAYING ONE STATE OFF AGAINST ANOTHER.

I THINK THIS ISSUE IS OF GREAT CONCERN TO THE AMERICAN PEOPLE. I HAVE PUBLISHED A BROCHURE, "FOUR WAYS TO SAVE ON YOUR CREDIT CARD PURCHASES". THE RESPONSE TO THIS BROCHURE TOOK ME BY SURPRISE. I HAVE RECEIVED OVER 10,000 WRITTEN REQUESTS FOR THE BROCHURE WHICH, FOR A STATE SENATE OFFICE, IS PHENOMENAL. THE FEELING AMONG MY CONSTITUENTS IS THAT THEY'RE BEING "TAKEN" BUT THAT THERE'S NOT MUCH THEY CAN DO ABOUT IT.

SOMETHING CAN BE DONE ABOUT IT, AND SOMETHING MUST BE DONE ABOUT IT. FOR IT IS OBVIOUS THAT WITHOUT LEGISLATION, THE RATES WILL ALWAYS GO UP QUICKLY, BUT VERY RARELY COME BACK DOWN. THE CONSUMER MUST BE PROTECTED FROM THAT.

Chairman ANNUNZIO. Thank you very much, Senator, for your excellent testimony.Mr. Fox, legislative representative, Consumer Federation of America. Your entire statement will be made part of the record.

STATEMENT OF ALAN FOX, LEGISLATIVE REPRESENTATIVE, CONSUMER FEDERATION OF AMERICA

Mr. FOX. I appreciate that. It is a pleasure to appear before this subcommittee. I find I have more than what I thought in common with the other people appearing here. I belonged for a number of years to the same credit union Governor Seger belonged to and cited, and I have my MasterCard from the bank which Mr. Hunt is an officer of.

The pattern of interest rate behavior over the past several years is pretty well known, and I think beyond dispute, and the charts on your right illustrate what has happened. Commercial rates, the rates charged to banks for money they borrow from other banks or from the Fed, have declined by nearly a half or in some cases more than a half in the past 4 years. Some consumer interest rates have dropped as well, by as much as 3, 3.5 points in the case of unsecured personal loans, which are perhaps the loans most analogous to the rates we are discussing.

But credit card rates have not gone down; in fact, they have gone up slightly during that period. There is only the slightest indication they may go down in the future. To the extent there is any such indication, it appears to be wholly in response to the scheduling of this hearing and the introduction of legislation that is the subject of this hearing.

I find it interesting that it is front-page news when a bank reduces its credit card rate by 2 percent. I guess I will feel a lot better about the trend when it is not front-page news for a bank to reduce its credit card rates and to respond properly to the market. Consumers know this pattern as well. Consumers are frustrated and concerned. They are frustrated by spending several years watching headlines about this interest rate dropping and that interest rate dropping, predictions their interest rates would drop sometime in the future that never seem to take place.

And I can guarantee any member of the subcommittee that if you talk to your constituents, you will find probably one of the top two or three issues that consumers are concerned about when they think about banks and when they think about the credit system are the interest rates on their credit cards. We have heard that from the members of organizations that belong to the Consumer Federation, we hear that from local news media, and hear that from individual consumers throughout the country.

What is not as well documented as this pattern of interest rates is what the cost has been to consumers of bank card interest rates. We estimate on the basis of Federal Reserve data that consumers are paying between $6 and $8.6 billion a year in interest just on bank credit cards. We are unable to develop a similar estimate for other credit cards.

A 1.5-percent reduction in the average interest rate, which would take the average interest rate to the level of 1980, about 17.1 percent, would save consumers $500 million to $700 million a year that could be spent on goods and services in the economy instead of on nonproductive interest income to banks.

We believe that rates have not come down because the market doesn't function properly, and I should say I am astounded by the testimony, the written testimony by Governor Seger, and by the American Bankers Association, which seems to suggest that there are only two possible market situations: either there is a monopoly or there is a fully functioning free market. There are a lot of shades in between, and there is a lot of room for market imperfection in between the range of monopoly and a fully functioning market.

I would like to outline some reasons we believe the market isn't functioning properly. First of all, simply the evidence of what has happened to the rates. I think it is proper to look at what the outcome of the market has been to decide whether it has been competitive or not. And the evidence is clear that there has been no decline in rates despite what anybody wants to say about competitiveness. Yes, the cost of funds is not as large an aspect of credit card pricing as other credit pricing, but there should be some relationship between credit card interest rates and the cost of funds.

I have seen in testimony that perhaps 30 percent of the cost of offering credit cards is related to the cost of funds. The cost of funds has declined by a third. That ought to translate into a 10-percent reduction in credit card costs or a decrease of, say, 1.8 to 2 percent in the rates. That simply hasn't happened, and I believe that failure to respond to a significant cut in cost is evidence the market is not functioning properly.

Why doesn't it function properly? Well, a large number of competitors is necessary for a market to function well, but it is not sufficient, and there are a variety of other reasons why the credit card market in particular doesn't work well. One is poor information; as has been suggested, consumers simply don't know how credit cards operate. There is an assumption every VISA card is the same, has the same rate, has the same conditions. That is enforced to some extent by the large amount of institutional advertising which VISA, MasterCard and other offerers do. There is not very good specific information about the terms and costs of credit for any particular credit card.

Although there are a large number of competitors, in many local markets there is probably a very small number of competitors. In many areas, they charge the same rates, and the only competition from outside that market is a market that offers cards at a higher rate.

I have spoken to a number of newspaper business writers who followed up on the reports we did, surveyed their local market, and found that every offerer, or almost every offerer, of credit cards charge the same rate, and the only competition was provided by mail order operations that charged even higher rates.

As has been suggested, annual fees operate to make it difficult for consumers to justify switching from one credit card to another. As the fees increase, it becomes simply costly and a barrier to moving from one card to another in order to take advantage of price decreases.

Probably most significantly, in contrast to any other form of credit, a consumer cannot calculate the true cost of a credit card. It is not something that is going to be solved by legislation; it is going to be addressed to some extent by greater disclosure. But in contrast to other forms of credit where the Truth in Lending Act and other disclosures permit a comparison of rates, permit consumers to roll all costs, such as loan origination fees, into a single APR, that simply cannot be done with open-ended credit.

The consumer cannot come up with a single figure that reflects the cost of any credit card and reflects all the factors that allows the consumer to price credit cards. None of this suggests credit cards are bad things nor the consumers don't get benefits from credit cards. It suggests those factors need to be acknowledged when public policy is set on the pricing of credit cards.

These market imperfections lead to some higher costs, because banks don't have any incentive to hold down the cost of credit cards. They know that the cost can generally be passed on to consumers. One of the ways in which the cost is being passed on, and again it has been explored, is the prevailing marketing of credit cards to people who are less creditworthy through techniques that seem to involve simply sending applications or sending preapproved credit cards to everybody in a particular ZIP Code or census tract or through some other selection mechanism.

I think it is significant that in the past couple of years, as credit card companies have marketed their cards more and more aggressively, that there has been a significant increase in losses due to uncollectability. That suggests that the banks are finding they are able to pass those costs on to all consumers, and, in fact, that is the case, because all consumers—not just the less creditworthy consumers—pay higher interest rates, as well. I believe there has been an inadequate response to fraud in credit cards because banks also have the ability to pass those costs on rather than addressing them aggressively.

Credit cards are lucrative to banks. The mass marketing that is taking place is evidence of that. It is evidence as well the market isn't working to hold down costs because the bank card issuers are able to pass those costs on to creditworthy customers as well as noncreditworthy customers.

We have made some recommendations on the legislation, which I would like to go over. We strongly support the portion of H.R. 3048 which directs the Federal Reserve Board to undertake a study to determine the relationship between credit card interest rates and the cost of funds to creditors and to determine the degree to which the rates reflect competition among creditors.

We would like to suggest, particularly based on the testimony we have heard today from the Fed, that language should be adopted that indicates to the Fed it must look beyond the number of competitors to other factors which also determine the existence of competition and the degree of competition in credit card markets, and we also urge Congress to require the Fed to establish an advisory committee to guide the research and make sure the Fed does not engage in superficial analysis, which frequently typifies its view of consumer issues.

Now, we find ourselves in a bit of an awkward position because CFA has argued in the past against Federal preemption of State interest rate ceilings. We believe the States have acted responsibly to balance the needs of consumers in the market for credit. However, credit cards differ in that a national market has been established which allows offerers of bank cards, in particular, to market those cards in a way that restricts the State's ability to regulate the cost of credit within their own borders.

The most expensive credit cards on the market today, at 19.8 and 21 percent, are those marketed nationally by banks which work from a single State with unusually high or no interest rate ceilings. We believe Congress could reduce credit card costs and place control of those costs at an appropriate level if it required banks to abide by the interest rate ceilings in the State of residence of the consumer. Offerers of gasoline credit cards and other retail credit cards already must abide by such limits.

If a national interest rate ceiling is established, Congress should be careful to insure other charges or conditions cannot be changed to thwart the intent of such a ceiling. There is probably little danger annual fees will be increased substantially to offset such a reduction. Consumers are sensitive to annual fees because they are very easy to compare in contrast to other charges.

But, for example, consumers would not be served if interest rates are reduced but grace periods for payment are removed. Restricting interest rates without restricting banks' ability to shift costs in such a manner would not be seen as positive legislation by many consumers.

For this reason, it may be fruitful to concentrate on improved disclosure. The Truth in Lending Act disclosures were written at a time when we did not have this broad national marketing of credit cards. It was unusual for a consumer to receive a mailing that had four or five pieces of multicolor promotions and a small application inside that said "Send this in and we will send you back a card." That is the prevailing way the market is heading now.

And we would urge the Congress and the Fed to reexamine the Truth in Lending Act and to change it to require solicitations for new credit card accounts to include a standardized table which shows all fees, interest rates and conditions such as grace periods under which fees or interest may be charged. The table should include every way in which a consumer might have to pay for the use of that credit, and if the fee is not disclosed in that table included with the solicitation, then the fee should not be permitted.

This information should be clearly and conspicuously disclosed with any material which includes application for a credit card or preapplication notice. We think this will go a long way to allowing consumers to look at the information that allows them to compare the costs of credit in a way they are not able to do now.

Again, Mr. Chairman, we thank you for the opportunity to testify and appreciate the interest of this subcommittee and of Congress in general in an issue that is of extreme importance to a large number of consumers across the country.

[The prepared statement of Mr. Fox with an attached report entitled "Consumer Interest Rates Remain High As Underlying Rates Plummet," and a letter regarding Bank of Virginia's credit card interest rate, follow:]

STATEMENT BY ALAN FOX, LEGISLATIVE REPRESENTATIVE, CONSUMER FEDERATION OF AMERICA ON CREDIT CARD INTEREST RATES

My name is Alan Fox. I am Legislative Representative for the Consumer Federation of America (CFA). CFA is the nation's largest consumer advocacy organization, with a membership of over 200 national, state and local consumer, rural, labor, cooperative, senior citizen and other groups that together have over 30 million individual members.

Four years ago, interest rates of all sorts reached record levels. The prime rate topped 20%. The discount rate reached 14%. Three-year Treasury Security constant maturities climbed over 16%.

Today, all of these rates have dropped substantially. The prime and discount rates are about half of what they were in 1981, 9.5% and 7.5%, respectively. Three-year Treasury Securities, cited by Federal Reserve Chairman Paul Volcker in a letter to Senator Dodd as "much more suitable as a possible index for consumer loans (than the discount rate)," are under 9.5%, more than a 40% decrease in four years.

Consumers have received some modest benefits from these sharp declines in interest rates. Fixed-rate mortgages, which in 1981 averaged over 15%, are now down to 12%. 24-month personal loans, once 19.2%, now average 15.8%. But credit card interest rates are today higher than they were in 1981. In August 1981, according to the Federal Reserve, credit card plans offered by a sample of commercial banks averaged 17.8%. In August 1985, those plans charged interest of 18.6%.

The Cost to Consumers

Last month, Consumer Federation of America issued a report outlining this discrepancy in interest rates. The pattern of interest rate behavior is well-known. What is less well known is the impact of these rates, in dollars and cents, on American consumers.

According to Federal Reserve statistics, revolving credit balances at commercial banks doubled in just three years, from $32.1 billion in May 1982 to $66.3 billion in May 1985. Almost all of this amount reflects credit card purchases. Based on estimates that half of this credit is payed off immediately each month, we calculated that banks alone are collecting over half a billion dollars in interest on credit cards every month, or $6 billion a year, on top of annual bank card fees of $2 to $3 billion a year, and on top of fees charged to merchants who accept bank cards. A reduction in credit card interest rates to the early 1980 level of 17.13% would save consumers over $500 million a year.

We have since been told by industry sources that perhaps as few as 30% of all consumers pay off their credit card balances each month. If this figure is accurate, then we have underestimated the cost of high interest rates to the American consumer. The cost to consumers of interest on credit cards would be over $8.6 billion a year using this figure, and consumers would save almost $700 million a year if rates dropped 1.5% to an average of 17.13%.

Consumers are Asking for Action

Credit card costs are thus of vital concern to American consumers. Consumers have waited patiently for credit card rates to decline to reflect these reductions in the cost of funds. Today, the consumers we hear from tell us their patience is wearing thin. The token responses of a few banks are insufficient; it should not be page one news when a bank cuts its credit card interest rates.

Bankcard Holders of America recently surveyed its membership on several issues relating to the cost of credit cards. BHA emphasizes annual fees as an issue; it is known as the best source for information on credit card plans without annual fees. But when BHA asked its members which of four issues they felt is the most important, 39% chose "Higher Interest Rates," while only 24% picked "Annual Fees," the next highest response.

We believe that consumers have waited long enough, and that their only recourse is to turn to Congress for action. We support whatever efforts are needed to bring credit card costs into line.

Why Rates are Too High

Interest rates on credit cards are too high. They are too high because they do not accurately reflect the costs of funds to banks, because there is insufficient true competition in the market, and because consumers are not provided with information they need to choose between competitors.

Bankers recognize that the market works to their advantage and that high interest rates can thus be charged to consumers with impunity. They have few incentives to reduce the costs of providing services, because costs can so easily be passed on to consumers. In fact, some banks are taking advantage of high interest rates to market credit cards to less and less creditworthy customers. All consumers, not just these new customers, pay the costs of that marketing in higher interest rates.

The Cost of Funds

We have no disagreement with the industry statement that credit cards, as unsecured loans, must carry higher rates than secured loans to reflect their greater risk. But the cost of funds is an important element in the cost of extending credit through credit cards, as banks were quick to point out when underlying interest rates were high and increasing. Credit card rates would, if the market were functioning properly, decline at least a modest amount to reflect dramatic decreases in the costs of funds over the past four years.

Bankers who now argue that the cost of funds is irrelevant would also have us ignore other changes in the cost of providing credit card services. Some of those other elements have or should have decreased in cost in the past four years. Greater automation and the spreading of costs to a growing base of card users should both act to cut costs.

Competition

The fact that rates have not come down is as good an indication as any that competition and the market are not functioning properly. We should not confuse the existence of a large number of providers of a service with the existence of competition. A large number of providers constitute a necessary, but not a sufficient, condition for a competitive market.

Competition is imperfect in all markets for consumer credit because of the disparity in information and market power between the offeror of credit and the consumer. The National Commission on Consumer Finance in 1972 stated that "the statistical evidence considered here indicates that competition cannot be relied upon at this point in time to establish rates at reasonably competitive levels in many states."

In testimony before the Senate counterpart to this subcommittee in 1983, Manuel Johnson, the Assistant Secretary for Economic Policy, Department of Treasury, stated that:

> Consumer loan rates are generally considered to be administered rates. That is, they are posted by lenders rather than set by the market interaction of supply and demand conditions. . .(S. Hrg. 98-73, March 17, 1983, p. 19)

At another Senate hearing a month later, Senator Proxmire asked Federal Reserve Board Governor J. Charles Partee to comment on that statement. Partee replied:

> There is a degree of administration, no doubt, in the consumer lending area. As a Virginia resident, I have recently been receiving notices from the department stores that they will be raising their rates to 21.6 percent beginning in April. And there's no economic or marketplace justification whatsoever for that. It simply reflects an increase in the usury ceiling permitted in the State of Virginia.
>
> . . .I would say, though, that market competition is growing all the time in the major consumer lending markets. Hardly a week goes by but that I, and I'm sure you, don't receive offers of credit from other States usually involving large amounts of money rather than low interest rates. . . . (emphasis added) (S. Hrg. 98-111, April 12, 1983, p. 48)

Credit cards, as well as other forms of open-end credit, present some conditions which make competition even more difficult than for other forms of credit. Annual fees, which are now charged almost universally, serve to lock in consumers to a particular card for an entire year. The open-end nature of the agreement makes a calculation of the true costs of credit difficult; fees cannot be rolled into the interest charge for a single, accurate annual percentage rate figure. Perhaps most important, the cost of open-end credit cannot be reduced to dollars and cents before an agreement is entered into as the costs of other credit contracts can. When all is said and done, the purchasers of a new home or a new car or a refrigerator compare figures for monthly payments more than they do APRs. But credit card plans by their nature cannot provide comparable information. In addition, most consumers are simply unaware of what market does exist. There is a general assumption, for example, that all Visa cards are identical.

Lack of meaningful competition has other implications for the costs of credit as well. We believe that banks have not responded aggressively to bank card fraud and have accepted accounts with higher probabilities of default because they can pass these costs on to consumers without risking loss of business. Restrictions on interest rates and other bank card costs may provide the incentive banks need to reduce both fraud and bad debts.

These are not arguments to restrict the use or availability of credit cards, but they do point to reasons why the market functions differently, and less competitively, than for other forms of consumer credit. Public policy should take these conditions into account, and not simply rely on a market which does not exist.

Disclosure Needed

Consumers do not receive clear information about credit card costs when they are asked to apply for credit cards. Current law provides for most disclosures only after the consumer has applied for and received a card. Disclosure requirements appear to be more suited to the days when credit card applicants more commonly applied for credit cards only at the bank at which they had other accounts.

Today, credit cards are marketed nationally by mail. These solicitations do include the amount of the annual fee and the interest rate, but these disclosures are rarely clear or conspicuous. They commonly appear in fine print on the back of the application, an application which is smothered in several pages of glossy four-color hype. Other important terms such as late fees and other charges and the method of calculation of balances on which interest may be paid are not disclosed.

As a result, applying for credit cards is a little like playing the lottery. Consumers do not find out what they need to make an informed choice until they have applied for and received the plastic card itself. Congress and the Federal Reserve Board should examine the Truth in Lending Act disclosure requirements with respect to open-end credit in light of this shift in credit card marketing and adopt requirements that all the conditions of credit cards be spelled out to a consumer in all promotional material which includes an application for credit.

Recommendations

We believe that it is appropriate for Congress to establish federal standards for credit card pricing. Credit cards, more than any other form of consumer credit, are marketed across state lines by banks which take advantage of favorable conditions in some states to create an interstate market.

We strongly support the portions of H.R. 3048 which direct the Federal Reserve Board to undertake a study to determine the relationship between credit card interest rates and cost of funds to creditors and to determine the degree to which rates reflected competition among creditors. We urge adoption of language which would indicate to the Fed that it should look beyond the number of competitors to other factors which also determine the existence and degree of competition in a market. We also urge Congress to require the Fed to establish an advisory committee, with consumer and industry representation, to guide the research and ensure that the study looks thoroughly at these issues.

CFA has consistently argued against Federal preemption of state interest rate ceilings. We believe that the states have acted responsibly to balance the needs of creditors and consumers in the market for credit. Credit cards differ from other forms of consumer credit in that a national market has been established which allows offerors of bank cards to market those cards in a manner which restricts the States' ability to regulate the cost of credit within their borders.

The most expensive credit cards on the market today are those marketed nationally by banks working from a single state with unusually high or no interest rate ceilings. Congress could reduce credit card costs and place control of those costs at the appropriate level if it required banks to abide by interest rate ceilings in the state of residence of the consumer. Offerors of gasoline and other retail credit cards must abide by such limits currently.

If a national interest rate ceiling is established, Congress should be careful to ensure that other charges or conditions cannot be changed to thwart the intent of such a ceiling. There is probably little danger that annual fees can be increased substantially; consumers are very sensitive to annual fees because they can be so easily compared. But consumers would not be served if interest rates were reduced but grace periods for payment were removed. Restricting interest rates without restricting banks' ability to shift costs in this manner would not be seen as positive legislation by consumers.

For this reason, it may be fruitful to concentrate instead on improved disclosure. The Truth in Lending Act should require each solicitation for new accounts to include a standardized table showing fees, interest rates, and conditions under which fees or interest may be charged. The table should include all ways in which consumers might have to pay for the use of a credit card, and fees not disclosed in the table should be prohibited. This information should be clearly and conspicuously disclosed with any material which includes an application for a credit card.

CONSUMER INTEREST RATES REMAIN HIGH AS UNDERLYING RATES PLUMMET

A report by
Alan Fox
Consumer Federation of America

Interest rates paid by banks and commercial borrowers have fallen 50% in a steady four-year decline, according to Federal Reserve Board statistics. But the rates banks charge consumers remain high, with credit card rates continuing to hover at record levels. As a result, consumers are paying banks tens of millions of dollars every month in excessive interest.

The prime rate peaked at 20.5% in the summer and early fall of 1981, and the discount rate, charged by the Federal Reserve to banks for short-term borrowing, peaked at 14% at the same time. Today, the prime rate stands at 9.5% and the discount rate has dropped to 7.5%. Both rates are at their lowest levels since 1978.

But the Fed's quarterly survey of consumer rates shows that consumers have received few benefits from these large reductions, even though the bulk of the reductions took place years ago and interest rates have remained relatively low and stable or declining for nearly three years (see table and graph).

According to the Fed, credit card interest rates charged by commercial banks, which averaged 17.8% in August 1981, climbed to 18.7% a year later while the prime dropped to 15% and the discount rate fell to 11%. In the three years since, while the prime and discount rates continued to drop, credit card rates remained essentially unchanged, fluctuating between 18.71% and 18.85%, a record high.

24-month personal loan rates averaged 18.5% in August 1981, and peaked at 19.2% three months later. In the four years since, these rates have dropped to just over 16%, a reduction of barely 3% in a period when the prime rate dropped 11% and the discount rate fell 6.5%.

The pattern of interest rate behavior in the past five years is made clear by the graph. Interest rates in 1980 and 1981 were extremely volatile, and consumer rate changes lagged behind changes in the prime rate, although they remained well above the discount rate. But for nearly four years, with the exception of a brief and relatively minor interruption in 1983-84, interest rates charged to large borrowers and to banks have declined sharply and steadily, while consumer rates have remained high. Interest rate volatility is a thing of the past, but banks are charging consumers as if nothing has changed since 1980.

Bank card fees cost $2 to $3 billion annually

These unreasonably high interest rates are being charged despite growing up-front fees for credit and dramatically increasing levels of debt, suggesting that there is no adequately functioning market mechanism to hold down the cost of many forms of consumer credit. With over 150 million MasterCards and Visa cards outstanding and annual fees generally between $15 and $20, banks are collecting $2 to $3 billion a year in fees.

Consumers pay $500 million a month in interest on bank credit cards

Fed statistics show that outstanding balances on bank cards are increasing at a phenomenal rate. Revolving credit balances at commercial banks doubled in just three years, from $32.1 billion in May 1982 to $66.3 billion in May 1985, while outstanding consumer credit balances as a whole increased by just 48%. Although 40% to 50% of these balances are paid off immediately, banks are collecting over half a billion dollars in interest on credit cards every month, or over $6 billion a year.

If the average rate charged on credit card balances dropped to the average rate at the beginning of 1980, 17.13%, consumers would save over $500 million a year in interest payments to banks.

Action needed to stop unreasonable charges

In 1982, the Consumer Federation of America first spotted this developing disparity between consumer and other interest rates, and urged the Federal Reserve Board to investigate whether consumers were being unfairly exploited. With three more years of evidence in, it is clear that consumers are paying hundreds of millions of dollars a year in excessive interest charges, on top of steadily increasing bank service fees, loan fees and credit card fees.

Contrary to bankers' claims, consumer interest rates do not respond to market changes. Rather, consumer interest rates are a function of the unequal relationship between lenders with the power to set rates and consumers who are forced to accept those rates or do without credit. Credit card interest rates are rarely disclosed to the consumer before an application for a card is made. CFA again calls on the Federal Reserve to investigate excessive consumer interest rates, and strongly urges Congress to consider legislation to limit or require advance disclosure of credit card interest rates and fees.

Interest Rates

Year/Month		Prime Rate	Discount Rate	24-Mo. Personal Loans	Credit Cards
1980	FEB	15.25	12.0	14.69	17.13
	MAY	18.39	13.0	16.31	17.31
	AUG	11.0	10.0	15.33	17.39
	NOV	15.5	11.0	15.54	17.41
1981	FEB	19.5	13.0	17.14	17.58
	MAY	18.43	13.29	17.48	17.71
	AUG	20.5	14.0	18.52	17.78
	NOV	17.29	13.0	19.21	18.04
1982	FEB	16.5	12.0	18.76	18.14
	MAY	16.5	12.0	18.90	18.41
	AUG	15.0	11.0	18.93	18.73
	NOV	12.0	9.5	17.99	18.75
1983	FEB	11.0	8.5	17.47	18.82
	MAY	10.5	8.5	16.57	18.79
	AUG	10.5	8.5	16.28	18.75
	NOV	11.0	8.5	16.39	18.75
1984	FEB	11.0	8.5	16.16	18.73
	MAY	12.0	9.0	16.35	18.71
	AUG	13.0	9.0	16.75	18.81
	NOV	12.0	9.0	16.63	18.82
1985	FEB	10.5	8.0	16.21	18.85
	MAY	10.5	8.0	16.09	18.74
	AUG	9.5	7.5	n.a.	n.a.

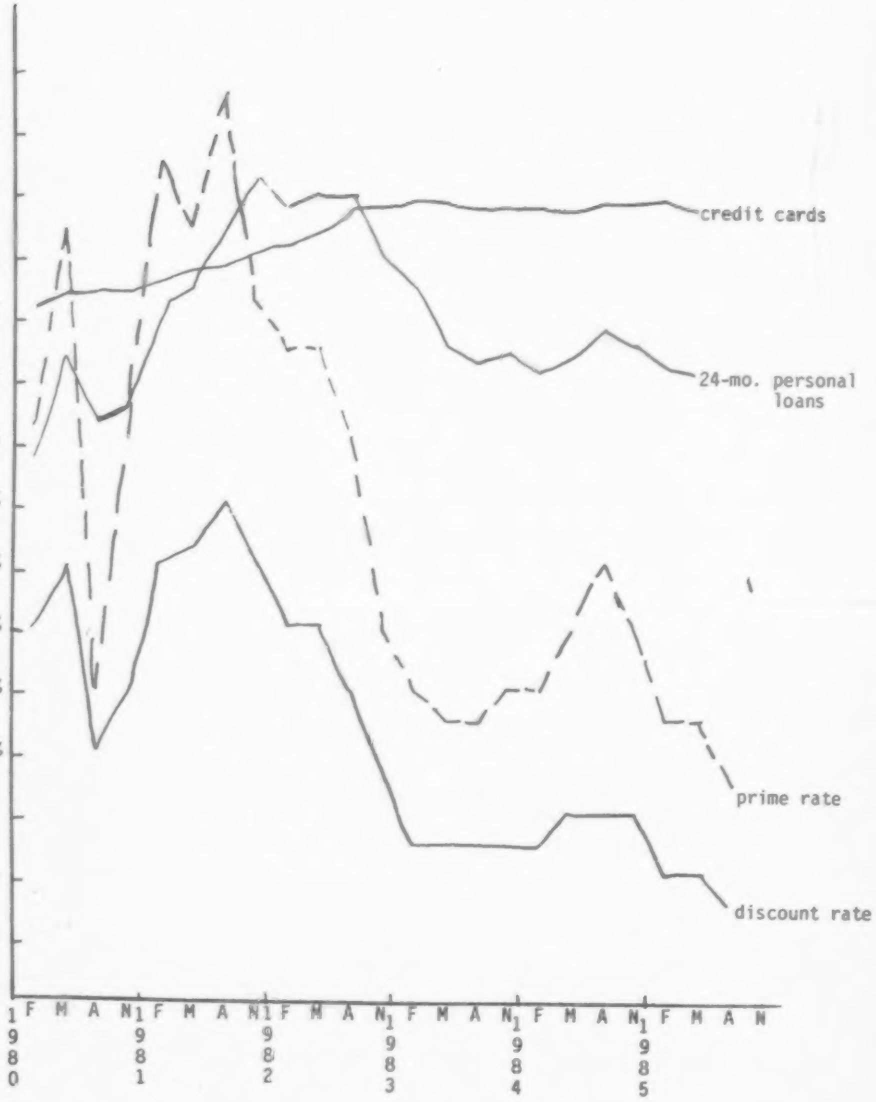
Source for all figures: Federal Reserve Board statistical releases.

Prime Rate
Average for first full week of month.

Discount Rate
Average for first full week of month at New York Federal Reserve Bank.

24-month personal loans
Credit card plans
Average APR at reporting commercial banks for first full week of month. The Fed surveys approximately 230 banks every quarter. August 1985 figures will be available in October.

INTEREST RATES IN THE 1980s



CFA Consumer Federation of America

RECEIVED
1985
SUBCOMMITTEE ON CONSUMER AFFAIRS
AND COINAGE

October 30, 1985

Hon. Frank Annunzio
Chairman, Subcommittee on Consumer
Affairs and Coinage
House Banking Committee
Washington, DC 20515

Dear Congressman Annunzio:

As a Bank of Virginia Mastercard customer, I was quite surprised to hear Mr. David K. Hunt, the bank's Executive Vice President, state at the October 29 hearing that Bank of Virginia's credit card interest rate is 18%.

I have enclosed a copy of the bottom portion of my most recent account statement. The interest rate shown is clearly 21%, not 18%.

I ask that this letter and the enclosure be made a part of the hearing record.

Sincerely,

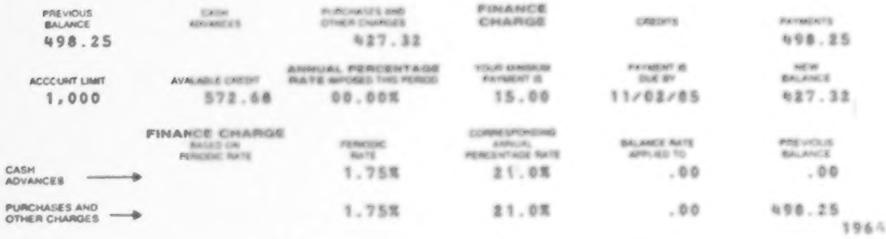
Alan Fox

Alan Fox
Legislative Representative

AF/ldg

Enclosure

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121



PREVIOUS BALANCE	CASH ADVANCES	PURCHASES AND OTHER CHARGES	FINANCE CHARGE	CREDITS	PAYMENTS
498.25		427.32			498.25

ACCOUNT LIMIT	AVAILABLE CREDIT	ANNUAL PERCENTAGE RATE IMPOSED THIS PERIOD	YOUR MINIMUM PAYMENT IS	PAYMENT IS DUE BY	NEW BALANCE
1,000	572.68	00.00%	15.00	11/02/85	427.32

	FINANCE CHARGE BASED ON PERIODIC RATE	PERIODIC RATE	CORRESPONDING ANNUAL PERCENTAGE RATE	BALANCE RATE APPLIED TO	PREVIOUS BALANCE
CASH ADVANCES →		1.75%	21.0%	.00	.00
PURCHASES AND OTHER CHARGES →		1.75%	21.0%	.00	498.25

1964

BANK OF VIRGINIA MASTERCARD ACCOUNT STATEMENT

Chairman Annunzio. Thank you very much.

Mr. Hunt, representing the American Bankers Association, you may proceed for 10 minutes, and your entire statement will be made part of the record, without objection.

STATEMENT OF DAVID K. HUNT, EXECUTIVE VICE PRESIDENT, BANK OF VIRGINIA, RICHMOND, VA, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. Hunt. Thank you. It is a pleasure to be here today.

Mr. Chairman, members of the subcommittee, my name is David K. Hunt. I am executive vice president of consumer products for the Bank of Virginia. I am here today on behalf of the American Bankers Association which represents over 90 percent of the commercial banks in this country. We are here to provide the subcommittee with our views on proposed legislation for Federal limits on credit card interest rates.

Mr. Chairman, much of the recent concern over credit card rates seems to stem from the declines over the past few years in some indexes, such as the "prime rate", without any across-the-board significant declines in the average credit card rate. Some view this as an indication that card issuers are garnering high profits at the expense of consumers. We think, however, that an objective look at the historic level of credit card rates, the nature of the credit card market and the array of value components that make up a credit card clearly show this allegation to be untrue. Credit cards are, and always have been, a safe, secure, flexible and convenient form of credit, although they are expensive to offer and maintain. The endemic costs and inherent risks of these programs to the issuer contribute to their costly nature.

The credit card over the past two decades has come to represent for consumers a safe, secure and convenient means of payment and credit access that is almost universally accepted. It has many features which contribute to its value over and above its function as a means of access to a line of credit. It can provide identification for check cashing, car rentals, hotel registration, and many other valuable services. It is used strictly as a payment mechanism by approximately a third of card holders who never incur interest charges. It allows consumers to travel with minimal or no cash providing maximum security. Bank cards also provide a rapidly expanding ability to access cash 7 days a week, 24 hours a day, at a nationwide network of ATM machines.

In order to provide this combination of convenience and security, the bank card industry has invested heavily to develop sophisticated and costly telecommunications systems and procedures which are unique to credit card credit. These added costs are a substantial contributing factor in making this flexible service one of the more costly forms of consumer credit. In short, these cards are devices of ever expanding utility and have developed in this way due to the highly competitive marketplace which has demanded and adopted each aspect of this expanding array of credit card value components.

This robust level of competition is quite obvious. It seems as though every day additional entrants announce their intention to

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This robust level of competition is quite obvious. It seems as though every day additional entrants announce their intention to break into the credit card field. Sears, Shell, Household International, to name just a few, are all attempting currently to promote new products. At the same time bank card issuers are competing for the loyalty of a finite number of consumers. In all, approximately 15,000 financial institutions participate in some form of card program.

In such an environment, the marketplace is a very accurate determinant of the value of the product. Any potential competitor who does not offer the appropriate value level for the cost of the product will be quickly abandoned for someone providing a better deal. As a banker involved on a day-to-day basis with the credit card business, I know from personal experience how well the marketplace is working. Legislation which would restrict our ability to compete freely would only serve to hurt the customer by restricting the availability of a valuable array of services.

A popular argument to make concerning the current level of credit card rates is the comparison between the prime rate and the current average credit bank card rate. This, however, is the classic apples and oranges comparison.

The prime rate, while not subject to a precise definition, is often referred to as the rate that banks charge their best, most creditworthy customers for secured, short-term credit. Credit card loans, in contrast, bear few of these characteristics.

Credit card customers may have no other relationship with the card issuing bank. While all card holders are checked for creditworthiness, the lack of a lengthy credit history or other dealings with the bank cannot rank such customers among the most creditworthy customers. It is, by definition, a more risky form of credit which is susceptible to difficult collections and bankruptcy losses.

It is also unsecured credit, so there is no collateral against which to take recourse if the loan goes bad. Finally, although one-third of all card users pay off their monthly balance and incure no finance charges, when a balance is maintained on a credit card, it typically is not a short-term loan. In fact, the average credit card loan is on the books for about 2 years.

It is true that in the past few years there have been declines in other interest rate indexes, without concomitant reduction in credit card rates. However, that disparity is best attributed to the willingness of the industry to take a long-term business risk and maintain a very unprofitable product line through some adverse times, rather than a profiteering motive in the current environment.

A review of the historical track of credit card rates displayed in exhibit A to our written statement, from 1972 to the present, shows this quite clearly. Credit card rates throughout the 1970's are not significantly different from the current average credit card rates. In the late 1970's and early 1980's, when the cost of funds significantly surpassed any previously recorded highs, credit card rates, due in many cases to usury ceilings, were unable to rise in accordance with the cost of money. Yet many institutions kept their portfolios despite losses during that period. The card business has only recently returned to profitability; and, given the reality of the market, it is clear that any effort to charge more than market rate will be quickly undercut by scores of aggressive competitors.

Those of us who are involved with this market on a day-to-day basis realize one important thing about consumers when it comes to making decisions that affect their financial affairs—consumers are very astute. If they feel they are not getting their money's worth, they will pick up their assets and walk across the street to the service provider they feel has the best combination of pricing and service.

Just a quick look around the Washington, DC, area shows the variety available to the shopping consumer. Although most offerings are at about the 18-percent level, the actual available range is from 14 percent to 21 percent. One bank even offers a variable rate card at 1 percent over prime which currently puts their rate at approximately 10.5 percent.

Even the credit union here at the House of Representatives, as you, Mr. Chairman, recently noted, has lowered its credit card rate to 16.8 percent. This program, however, accrues interest from date of posting. There is no free period. To some, however, this may provide the best cost/value combination.

On the national scene, several large issuers have recently lowered card rates. A recent telephone survey of several metropolitan areas around the country found in most cities at least a 3-percent variation among issuers. In fact, Mr. Chairman, a recent article in the Washington Times, which we have attached to our written testimony, indicates we may be witnessing the beginning of a credit card rate war.

Rate, however, is no longer the only component of value when shopping for a credit card program. Some banks are offering rebates or other incentives. Discount shopping services and insurance offerings are also becoming common and surely will proliferate as new entrants approach the market.

In summary, Mr. Chairman, it is a very competitive marketplace in which we operate, with a customer base of very value conscious consumers. If we don't provide a product that the consumer feels is worth the price, if value to the consumer does not equal or exceed their cost, we will not be selling the product.

Thank you, Mr. Chairman, for allowing me to present our views.

I would be glad to try and answer any questions you may have.

[The prepared statement of David K. Hunt on behalf of the American Bankers Association with an attached report entitled "Interest Rate Controls on Credit Cards—An Economic Analysis" follows:]

Statement of the
American Bankers Association
Before the
Subcommittee on Consumer Affairs & Coinage
House Banking Committee
On
H.R.1197 and H.R.3408
Legislation To Limit Credit Card Interest Rates

October 29, 1985

Mr. Chairman, members of the Subcommittee, my name is David K. Hunt. I am Executive Vice President of Consumer Products for the Bank of Virginia. I am here today on behalf of the American Bankers Association, which represents over 90% of the commercial banks in this country. We are here to provide the Subcommittee with our views on proposed legislation for federal limits on credit card interest rates.

H.R.1197, introduced by Congressman Biaggi, would limit the interest charged on "any consumer credit transaction involving a credit card" to 5 percentage points above the discount rate on 90-day commercial paper at the local Federal Reserve Bank. H.R.3408, introduced by Congressman Schumer, would limit the interest charged on "any credit extended through the use of a credit card" to 6 percentage points above the percentage yield on 3-month Treasury bills during the previous calendar quarter. The controls in H.R.3408 would not take effect if an initial study by the Federal Reserve Board determined that credit card interest rates have reflected creditors' costs of funds and competition for new accounts.

Mr. Chairman, much of the recent concern over credit card rates seems to stem from the declines over the past few years in some indexes such as the "prime rate," without any across the board significant declines in the average credit card rate. Some view this as an indication that card issuers are garnering high profits at the expense of consumers. We think, however, that an objective look at the historic level of credit card rates, the nature of the credit card market, and the array of value components that make up a credit card, clearly show this allegation to be untrue. Credit cards are, and always have been a safe, secure, flexible and convenient form of credit, although relatively expensive to offer and maintain. The endemic costs and inherent risks of these programs to the issuer contribute to their costly nature.

Allegations of some sort of "profiteering" pre-suppose a relatively noncompetitive market with only a few participants. This is simply not a description of the credit card marketplace. Competition is robust: there are thousands of card issuers, millions of cards in circulation, and varied entrants with new products surfacing frequently.

Price controls such as those contained in the legislative proposals under consideration here only have the potential to be effective when a monopoly situation exists. In the monopolistic case, where a sole provider of a product is able to impose a price on the market by controlling supply, in theory, a regulatory limit may be effective. The unfortunate experience resulting from our brief encounter with price controls in early

1980 should serve as a painful reminder of the folly resulting from the imposition of governmental price controls on a competitive marketplace. The spring of 1980 saw restrictions on the availability of credit card credit. New cards were very selectively issued. Credit qualifications were tightened. Minimum payment schedules were increased. Some banks actually abandoned the business because of the burdens imposed, thus contributing to a temporarily less competitive marketplace.

Mr. Chairman, we are having prepared a detailed economic analysis of the proposal to impose interest rate controls on credit cards which will examine, in some detail, the credit card market and the effects these proposals could have if enacted. This report will be submitted to the Subcommittee in the very near future. We hope the Subcommittee will allow that report to be included in the record of these hearings.

Mr. Chairman, it is our strong belief that these bills, however well intentioned, could result in a significant reduction in available credit, services and choices for consumers.

The Value Of A Credit Card Is Understood By Consumers

The credit card over the past two decades has come to represent for consumers, a safe, secure, convenient means of payment and credit access that is almost universally accepted. It has many features which contribute to its value over and above its function as a means of access to a line of credit. It can provide identification for check cashing, car rentals, hotel registration and many other valuable services. It is used strictly as a payment mechanism by approximately a third of cardholders who never incur interest charges. It allows consumers to travel with minimal or no cash-providing maximum security, since federal law limits any losses to the consumer from a lost or stolen card to $50. Bank cards also provide a rapidly expanding ability to access cash seven days a week, 24 hours a day at a nationwide network of ATM machines.

In order to provide this combination of convenience and security, the bank card industry has invested heavily to develop sophisticated and costly telecommunications systems and procedures which are unique to credit card credit. These added costs are a substantial contributing factor in making this flexible service one of the more costly forms of consumer credit. In short, these cards are devices of ever expanding utility, and have developed in this way due the highly competitive marketplace which has demanded and adopted each aspect of this expanding array of credit card value components.

The Market For Credit Card Services Is Highly Competitive.

It seems as though every day additional entrants announce their intention to break into the credit card field. Sears, Shell, Household International, to name just a few, are all attempting currently to promote new products. At the same time, Mastercard, VISA and other bank card issuers, are competing for the loyalty of a finite number of consumers. In all, approximately 15,000 financial institutions participate in some form of card program.

In such an environment, the marketplace is a very accurate determinant of the value of the product. Any potential competitor who does not offer the appropriate value level for the cost of the product will be quickly abandoned for someone providing a better deal. As a banker involved on a day to day basis with the credit card business, I know from personal experience how well the market place is working. Legislation which would restrict our ability to compete freely would only serve to hurt the consumer by restricting the availability of a valuable array of services. However well intended, we think these legislative proposals are counter-productive.

The Costs Of Extending Open-end Credit Through A Bank Credit Card Are Higher Than Through Traditional Installment Credit

Before we go any further, Mr. Chairman, let me briefly outline for you some of the operational differences between the traditional installment loan, such as an automobile loan or personal loan, and the way in which a credit card plan operates. This description may help to clarify some of the additional steps and costs involved in these programs.

For a traditional installment loan, the applicant fills out an application which is then reviewed by the loan officer, generally as part of a personal interview. A credit report may be requested, and depending on the amount, the loan officer may have the authority to approve the loan without further consultation. The bank advances the funds, a payment book is generated, and once a month the consumer sends his check to the bank or authorizes the payment amount to be deducted automatically from a checking or savings account. Every thing else being equal, there are no significant ongoing costs for that loan. After the startup costs, the processing of the monthly payment and the risk of credit extension, are the only continuing costs. This contrasts markedly with the credit card system.

Application - New Accounts

The credit card application process, while essentially similar in concept to the installment loan application process, is different in two key respects, risk and volume.

Credit card applications are normally received by mail, so personal interviews with the prospective customer are not typical. This aspect of credit card programs makes them inherently more risky, since the consumer usually is not known to the bank, and risk is one of the key elements in pricing any loan product.

The second key distinguishing factor is volume. Most bank card operations process a high volume of applications. It is a business that is built upon volume. The average bank card transaction or "loan" is only $50. The average active account makes less than 40 transactions a year. Since over 50% of the dollar volume of transactions is paid off every month and never incurs a finance charge, card programs generate high volumes to defray the enormous fixed costs associated with running such an operation. Obviously, processing such a volume of applications, verifying creditworthiness, approving the application and issuing the cards can be a very labor intensive and costly process.

Upon credit approval, an account number is assigned and a master file record is established on a computer system which contains such information as the source of application, credit limit, billing cycle, issuance date, and customer information. A credit card is embossed and encoded and mailed to the cardholder along with the appropriate legal disclosures. Pre-mailers and follow-up mailers are frequently used for address verification and early detection of problems with mail theft.

Sales Transaction Authorization

Once the consumer is in possession of a valid card, they are able to take advantage of the conveniences bank cards offer. However, there are significant supporting costs which make this convenience possible.

Before a merchant may complete a transaction, authorization must often be received from the card issuing bank. Most merchants must seek such authorization if the dollar amount of the transaction exceeds the merchant's "floor limit."

Most merchants have a "floor limit" for authorizations. This limit recognizes that absent instantaneous authorization, it is not feasible or practical to require a telephone verification of each card transaction. "Floor limits" are therefore established, and transactions below that amount do not require specific authorization. These procedures recognize a certain level of risk accepted in return for consumer convenience. The costs and losses incurred due to these procedures are necessarily built into the system.

When a merchant needs an authorization he does so by first notifying his bank. The merchant bank passes the request to the bank card authorization communications network who acts as a "switch" to contact the card issuing bank. Upon receipt of the authorization request, the issuing bank checks the current status and available credit of the account and issues either an approval or denial. Response is communicated to the merchant who completes the sale if authorized. Providing this service requires an extensive network of telecommunications and computer equipment to allow quick and accurate authorizations.

Sales Transaction Processing

The merchant accumulates paper sales receipts or captures credit card sales data electronically and deposits the paper credit card receipts or machine readable sales data with its bank. The merchant bank then credits the merchant's account for the value of the receipts less a discount representing a fee for processing. If the bank that originally issued the card and the bank where the merchant deposits the sales slip are the same institution, then reconciling the accounts is an easy task. However, in a great many cases, the bank where the merchant deposits its sales slips and the card issuing bank are thousands of miles apart. Therefore, a mechanism or communications network, must exist to transmit the sales data from the merchant's bank to the issuing bank so it can be posted to the consumer's account.

The credit card sales data may be processed by the merchant bank itself or an agent for the bank, such as a correspondent bank or a data processing firm. Processing begins by converting the data on the sales drafts to machine readable form. Once converted, the data are transmitted to the data interchange system operated by the card company. The card company sorts the transactions by card issuing bank and calculates the dollar amount due to each merchant bank or its agent, as well as the amount due from each issuing bank. Amounts due and owed are then netted for each bank.

Cardholder Payment

Each month the cardholder receives a billing statement. The statement contains a detailed list of the charges during the month, previous balance, payments made, etc. In addition to providing this monthly statement, the issuer must establish and maintain procedures pursuant to federal law to quickly resolve any alleged errors in the billing statement. Assuming however, that all is in order with the statement, the cardholder returns the payment stub and check which the bank microfilms, endorses and sequentially numbers to facilitate retrieval should questions arise in the future.

A key aspect of the consumer's payment decision is whether to pay in full and essentially just use the payment aspect of the card, or to pay only part of the balance, thus activating the credit feature. One-third of cardholders use credit cards strictly as a value exchange mechanism. The card statement provides a convenient accounting of their purchases for the month. A single check can be written for the full amount due, in most cases incurring no interest charge for the loan of those funds for as long as two months.

As you can see, Mr. Chairman, there are a great many behind the scenes people, systems and procedures that exist to make credit cards such a convenient secure payment/credit system. In addition to the unique aspects of the system discussed above, recently there has developed a significant new cost to the system, that of fraud and counterfeiting. This problem has always existed to a certain extent, but in recent years a new breed of credit card criminals has developed. These criminals have specialized in obtaining valid credit card numbers and "manufacturing" counterfeit cards, or in some cases, altering the numbers on stolen cards. This problem led the industry to devote substantial resources to developing a card that was more difficult to alter. The major bank card associations have adopted the hologram as a first step in improved card security. The hologram appears on the lower right hand corner of new VISA and MasterCards. An attempt to alter the card will result in a change in the hologram which will alert merchants to a potential problem with the card. Research into new card secure materials and procedures is an ongoing process.

There has also been a move to electronic authorizations. To the extent that each transaction can be verified, card and system security is improved. As electronic cash registers and phone terminals capable of reading information directly from a credit card's magnetic stripe become more common, it will be practical to have an ever increasing number of transactions specifically approved. Investment in this technology is expensive but worthwhile to maintain the integrity and security of the system.

The cards themselves generally are valid for only a year or two, thus limiting the exposure to the system. However, this security measure also requires the bank to re-issue cards on a fairly regular basis. Again, imposing an ongoing cost of operation.

In short, Mr. Chairman, there are significant additional costs which are endemic to this form of credit, that are not associated with other forms of consumer credit. These costs, however, are the result of a level of convenience and utility that is unique to the credit card.

Allegations That Banks Are Making Exorbitant Profits On Credit Cards Are Not Founded In Fact

A popular argument to make concerning the current level of credit card rates, is the comparison between the "prime rate" and the current average credit bank card rate. This, however, is the classic apples and oranges comparison.

The "prime rate" while not subject to a precise definition, is often referred to as the rate that banks charge their best, most credit worthy customers for secured short term credit. Credit card loans, in contrast, bear few of these characteristics. Furthermore, from an historical perspective, there traditionally has been little correlation between credit card rates and prime rate.

As discussed earlier, credit card customers may have no other relationship with the card issuing bank. It is such a competitive market that customers tend to seek out the best deal and obtain their cards from whatever institution they feel has the best product/price offering. Institutional loyalty is not a major factor with this product line. While all cardholders are checked for creditworthiness, the lack of a lengthy credit history or other dealings with the bank cannot rank such customers among the "most creditworthy" customers. It is, by definition, a more risky form of credit which is susceptible to difficult collections and bankruptcy losses. It is also unsecured credit, so there is no collateral against which to take recourse if the loan goes bad. Finally, although one-third of all card users pay off their monthly balance and incur no finance charges, when a balance is maintained on a credit card, it typically is not a short term loan. In fact, the average credit card loan is on the books for about two years. To show the historical lack of correlation between "prime" and credit card rates, we have attached as Exhibit A to our testimony a chart which shows the "prime rate" in comparison to credit card rates and personal loan rates from 1975 through 1985. It is clear from this chart, that credit card rates never have had any relationship to prime rate.

By comparison however, personal loan rates, both commercial bank and finance company, show a track much closer to parallel with credit card rates. These loans bear some of the same characteristics of credit card loans, (unsecured personal credit usually of 1-2 year duration) but do not have the same level of administrative overhead. It is clear that for unsecured personal loans of this type, there are less expensive (bank personal loans) and more expensive (finance company loans) alternatives to the credit card should consumers desire to use them.

It is true that in the past few years there have been declines in other interest rate indexes, without concomitant reduction in credit card rates. However, that disparity is best attributed to the willingness of the industry to take a long-term business risk and maintain a very unprofitable product line through some adverse times, rather than a profiteering motive in the current environment. A review of the historical track of credit card rates displayed in Exhibit A, from 1972 to the present, verifies this analysis. Credit card rates throughout the 1970's are not significantly different from the current average credit card rates. In the late 70's and early 80's when the cost of funds significantly surpassed any previously recorded highs, credit card rates, due in many cases to usury ceilings, were unable to rise in accordance with the cost of money. Yet many institutions kept their portfolios despite losses during that period. Many other providers sold their portfolios because they were a drain on bank performance. The card business has only recently returned to profitability; and, given the reality of the market, it is clear that any effort to charge more than the market rate will be quickly undercut by scores of aggressive competitors.

The Current Extremely Competitive Marketplace Is The Best Determinant Of Value For Credit Card Services.

Mr. Chairman, today there are approximately 130 million bank cards in the possession of consumers. In addition, there are over 350 million retail credit cards (Sears, J.C. Penny, etc.), 113 million oil company cards and several million other types of credit cards. They are issued by thousands of different retailers, banks, savings and loans, merchants, oil companies, and others. Over 13,000 banks issue VISA, MasterCard, or other bank cards. In addition to the existing competition, there are entrants appearing almost every day. Sears has begun testing their Discover card. Shell has announced a new multi-purpose card. Household International has also indicated intentions to market a similar product.

It seems quite apparent that the credit card industry is a marketplace that has been competitive and is rapidly becoming even more competitive.

Those of us who are involved with this market on a day to day basis realize one important thing about consumers when it comes to making decisions that affect their financial affairs - consumers are very astute. If they feel they are not getting their money's worth, they will pick up their assets and walk across the street to the service provider they feel has the best combination of price and service.

Consumers recognize the value of the credit card and the services it provides. It is a safe, convenient, secure method of payment for a vast array of retail purchases. It provides a monthly accounting of those purchases and allows the option of either full payment (with the additional benefit of a free loan from date of purchase to date of payment) or partial payment and the use of the credit feature of the plan. If the interest rate on the card is perceived to be too high, there are other alternatives available, such as a personal loan or check overdraft credit, to avoid the use of the card entirely or to pay off the balance and avoid further card related finance charges.

Bank credit cards also offer nationwide cash advance capability. This facet of the credit card can be *invaluable* to the consumer caught short of cash and far from home.

Card programs are also becoming much more diversified in the products and services they offer consumers, and in their pricing strategies. There are plans, secured by home equity, which offer significantly lower rates. Other issuers have various combinations of rates and fees which allow consumers to pick the combination which is best for them.

Just a quick look around the Washington, D.C. area shows the variety available to the shopping consumer. Although most offerings are at about the 18% level, the actual available range is from 14% to 19%. One bank even offers a variable rate card at 1% over prime, which currently puts their rate at approximately 10.5%.

Even the credit union here at the House of Representatives, as you Mr. Chairman recently noted, has lowered its credit card rate to 16.8%. This program, however, accrues interest from date of posting. There is no free period. To some, however, this may provide the best cost/value combination.

On the national scene, several large issuers have recently lowered card rates. A recent telephone survey of several metropolitan areas around the country found in most cities, at least a 3% variation among issuers. In fact, Mr. Chairman, a recent article in the Washington Times, which we have attached to our testimony, indicates we may be witnessing the beginning of a credit card rate war.

Rate, however, is no longer the only component of value when shopping for a credit card program. Some banks are offering rebates or other incentives. Discount shopping services and insurance offerings are also becoming common and surely will proliferate as new entrants approach the market.

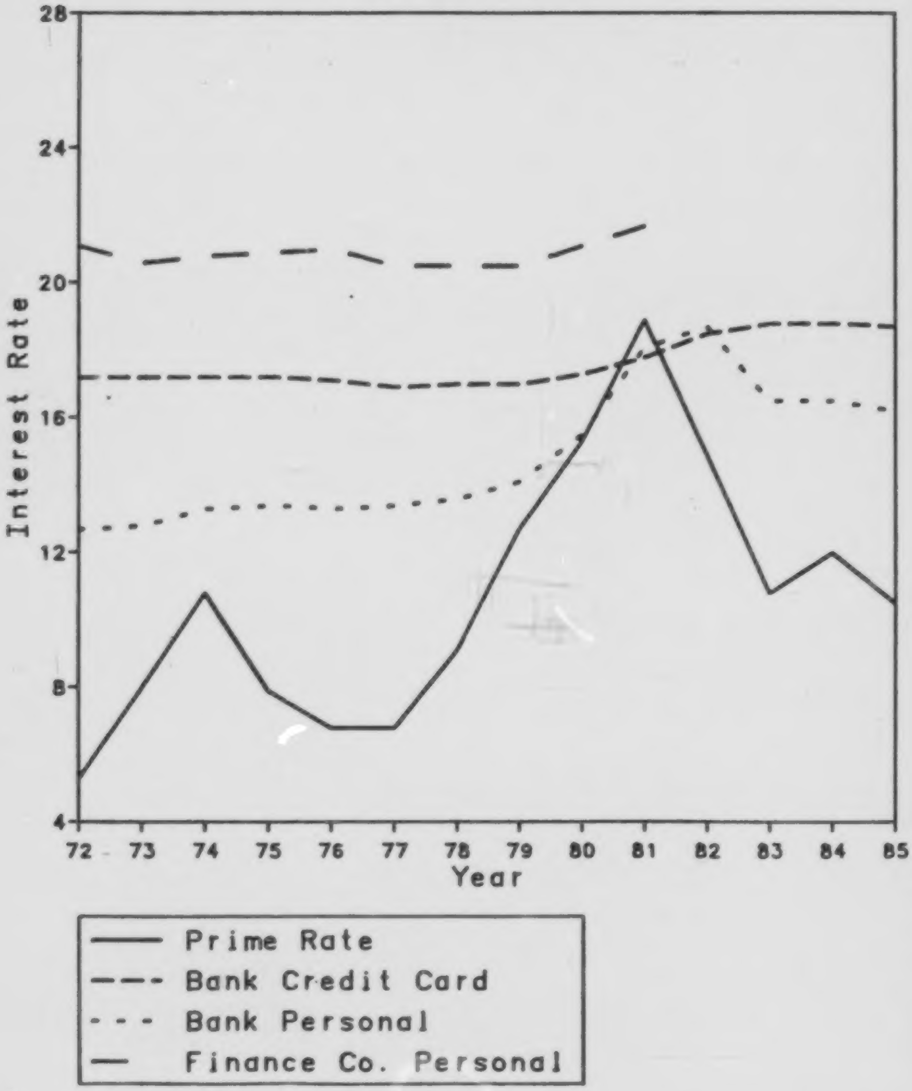
In summary Mr. Chairman, it is a very competitive marketplace in which we operate, with a customer base of very value conscious consumers. If we don't provide a product that the consumer feels is worth the price - if value does not equal or exceed cost - we will not be selling the product.

Thank you Mr. Chairman, for allowing me to present our views.

I would be glad to try and answer any questions you may have.

EXHIBIT A

MOVEMENTS IN VARIOUS CONSUMER AND MONEY MARKET INTEREST RATES 1972–1985



PAGE 10C / *FRIDAY, OCTOBER 25, 1985* The Washington Times

Credit card rate war may be under way

By Laura Outerbridge
THE WASHINGTON TIMES

A credit card rate war may be brewing in New York — home to some of the nation's biggest bank card issuers.

Manufacturers Hanover Trust Co., the nation's fifth largest card issuer, was first to throw down the gauntlet earlier this month when it lowered its annual finance charge on Visa and Master Card from 19.8 percent to 17.8 percent.

More recently, the Bank of New York has undercut Manny Hanny's new rate by almost 1 point, heralding its new 16.98 percent finance charge with a full-page ad in The New York Times. The average card rate among New York banks is 19.8 percent.

"The overall competitive situation" as well as "the cost of funds" contributed to a decision to lower rates from 17.94 percent, said Bank of New York spokesman Scott Peterson.

"Certainly we believe we can increase our market share by being more competitive," said Donald Colby, the bank's senior vice president in charge of credit card operations.

Both consumer groups and bank organizations claim the new finance rates as a victory.

"Consumers are becoming more aware of the fact that interest rates are too high, and banks are getting nervous — they want to be first to lower their rates," said Karen Harris, a worker with Bank Card Holders of America, a Washington consumer information group.

The credit card rate issue has figured prominently in the press, she said, as a result of three bills currently before Congress to slap a floating rate ceiling on the charges.

But Kirk Willison, spokesman for the American Bankers Association, said the move by Manny Hanny and Bank of New York showed how the banking system could work competitively without a rate cap.

"Some [banks] are still pretty tight," Mr. Willison said. "They aren't making much profit from the accounts, with rates of 18 percent."

But the larger the card base, the easier it is for a bank to offer lower finance charges, he said. "There are certainly economies of scale."

Interest Rate Controls on Credit Cards -- An Economic Analysis

Lexecon Inc.
October 1985

Executive Summary

The attached report assesses the economic merits and likely effects of the proposals to impose a national interest rate ceiling on credit cards. The proposed ceilings would be pegged at 5 or 6 percentage points above rates on Treasury bills or other commercial money instruments. This would set credit card interest rates at about 12-13 percent at present. Credit card rates are currently about 18-19 percent on average, which is higher than rates for some other kinds of consumer credit (secured automobile loans) but lower than rates for other kinds (finance company loans).

The report shows that the proposed controls are unjustified and would be harmful to consumer welfare. The report's most important conclusions are these:

1. The supply of credit card credit is intensely competitive. Thousands of banks, credit unions, savings-and-loan associations, retailers, and gasoline companies supply credit cards. Many of them issue cards on a nationwide basis. Even the largest card issuers, such as Sears and Citicorp, have only a small share of the supply of credit card credit. In addition, other kinds of consumer credit are effectively competitive with credit card credit. Market concentration in the supply of credit card credit alone is far below what would be necessary for interest rates to exceed costs of supply.

2. Credit card credit has been growing rapidly. Since 1980, balances on bank card accounts have grown nearly 30 percent per account in real terms, and the number of accounts has grown over 40 percent. These rates far exceed the growth in consumer spending and in the over-20 population. Credit card interest rates (and related prices) have remained relatively stable during this period, so the growth in credit balances and accounts indicates a substantial increase in demand for credit card credit.

3. The level and stability of credit card interest rates does not indicate excessive pricing or justify rate controls. Most of the costs of supplying credit card credit are administrative costs, not costs of funds to card issuers. While costs of funds in commercial money markets have declined in recent years, the demand for credit card credit

has increased. The general response has been an expansion and improvement in credit card services rather than a reduction in interest rates: card issuers have greatly increased their credit lines per account, have offered a wider array of card features, and have offered credit to new (riskier and therefore costlier) groups of consumers who previously could not obtain credit cards.

Recently, some major card issuers have reduced their interest rates substantially, but it is too soon to tell whether rates will decline in general. This will depend on future trends in the costs of supply and level of demand for credit card credit.

4. Following the recent wave of state deregulation of credit card interest rates, cards issued from control-free states have been much more successful with consumers than cards from states with interest rate ceilings. Since 1980, the national share of bank card credit issued from states without rate ceilings has increased over 13 percent. At the same time, the share of credit from states that still impose rate ceilings had fallen over 17 percent. Bank card credit from states with "strict" rate controls has fared worse with consumers than credit from states with "moderate" controls. Bank card credit from states with strict "floating" ceilings (similar to those in the proposed national controls) has done worst of all.

This market evidence refutes the argument that consumers benefit from interest rate ceilings: consumers already may choose between cards with and without rate ceilings -- and they are choosing unregulated cards in rapidly growing numbers.

5. A national interest rate ceiling would lead to a contraction in the supply of credit card credit. This would deflect many consumers to more costly or less convenient forms of borrowing, and would reduce competition in the supply of consumer credit. The economic effects of a national rate ceiling would be similar to, but more damaging than, those already observed in states with strict ceilings on credit card rates. Card issuers would "reprice" their services to some extent -- for example by raising annual fees or increasing charges for late payments and account inquiries -- but the opportunities for repricing appear to be limited. Issuers would then be forced to allocate credit by non-price means -- such as by tightening credit standards and restricting cards to local markets and regular customers -- in an effort to reduce their costs to the prices permitted by the rate ceiling. Consumers who could not obtain credit card credit would substitute other forms of credit which would be more costly (loans from finance companies or local retailers) or less convenient (increasing loans on automobiles or houses and carrying larger cash balances).

The increased segmentation of consumer credit markets by credit-risk, income, and other consumer groups would reduce competition in the supply of credit between banks, other depository institutions, retailers, and finance companies. The contraction of bank cards from national to regional markets and regional to local markets would similarly reduce geographic competition. In general, there is sufficient competition among suppliers of each type of consumer credit to keep interest rates and other prices at costs of supply. Nevertheless, the reduction in competition would be serious in some circumstances. In particular, direct lending by retailers would be less constrained by the availability of credit cards to consumers, and credit markets in many smaller communities -- which have become substantially more competitive in recent years due to wave of state interest rate deregulation and the emergence of national credit cards -- would lose some of these newly achieved economic benefits.

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Interest Rate Controls on Credit Cards -- An Economic Analysis

Lexecon Inc.

October 1985

1. Introduction and Summary

This paper, prepared for the American Bankers Association, MasterCard International Inc., and Visa U.S.A. Inc., assesses the economic merits and likely effects of the proposed national controls on credit card interest rates. Three such proposals have been introduced in the United States Congress; each would establish a floating usury ceiling ("floating" because the ceiling is determined by reference to a market rate rather than by statute or an administrative agency) for credit issued through credit cards.

H.R. 1197, introduced by Mr. Biaggi, would limit the annual rate of interest charged on "any consumer credit transaction involving a credit card" to 5 percentage points above the discount rate on 90-day commercial paper at the local Federal Reserve bank. S. 1603, introduced by Senator Hawkins, would limit interest to 5 percentage points above the percentage yield on 6-month Treasury bills during the previous calendar year. H.R. 3408, introduced by Mr. Schumer, would limit interest to 6 percentage points above the percentage yield on 3-month Treasury bills during the previous calendar quarter. The controls in the Schumer bill would not take effect if an initial study by the Federal Reserve Board determined that credit card interest rates have reflected the costs of funds to card issuers and competition among them for new accounts.

Usury laws are among the oldest forms of government price controls, and for this reason are among the best understood in both theory and practical effect.[1] Economists have found, virtually without exception, that usury controls are either ineffective or are harmful to consumer welfare -- particularly to the welfare of those they ostensibly seek to protect.[2] Partially for this reason, and partially because recent advances in information technology have made credit markets more competitive and harder to "control" through government regulation, most state usury laws have been repealed or substantially relaxed in recent years.[3] The credit card proposals are an exception to the general trend.

The conclusions of this paper are similar to those of earlier economic studies: we find that the proposed

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1. The leading scholarly account of the Biblical origins of usury restrictions, and their erosion during the Reformation, is Benjamin Nelson, *The Idea of Usury* (U. of Chicago Press 1969); see also Richard L. Peterson, "Consumer Finance," in George J. Benston (ed.), *Financial Services* (Prentice-Hall 1983) 105.

2. Contemporary studies of the economic effects of state usury laws are discussed in Section 5 of this paper.

3. According to data compiled by the American Bankers Association, of the 48 states which imposed ceilings on credit card interest rates before 1979 (California and New Hampshire did not), 19 states have since raised their ceilings and another 15 have repealed them outright.

controls are unjustified, and would be harmful to both borrowers and lenders.

The apparent basis of the proposals is that credit card interest rates are generally somewhat higher than rates for other forms of consumer and commercial credit, and have been more stable over time. In particular, rates for credit card credit have generally not declined along with rates in commercial money markets in the last few years. As we will explain, however, neither of these circumstances is appropriate cause for concern, or suggests underlying economic problems that might be resolved by government intervention.

The Federal Reserve Board study proposed in H.R. 3408 suggests a closely related concern: that the supply of credit card credit may be insufficiently competitive, leading to excessive interest rates ("excessive" meaning greater than costs of supply, including competitive returns on investments). Yet existing data amply demonstrate that the supply of consumer credit, both through credit cards and other means, is highly competitive, and that no card issuer could charge rates exceeding costs of supply except in rare and short-lived circumstances.

Forcing credit card interest rates below market-clearing levels can only create an artificial gap between the amount of credit supplied and the amount demanded -- which in turn will lead to a variety of unfortunate results, similar to those that have led to the repeal of many state interest ceilings. The most important results are likely to be:

(a) credit card issuers will adopt less efficient methods of pricing card services than they employ at present, (b) many consumers who presently finance purchases through credit card credit will be deflected to other, more costly or less convenient forms of borrowing, and (c) competition between suppliers of credit card and other forms of consumer credit will be reduced.

The credit card proposals differ from state usury controls in two important respects -- they would be applied at the national rather than state level, and would apply to only one of many forms of consumer credit. These features make the proposals particularly unpromising from an economic standpoint. Following the recent wave of interest rate deregulation, credit card credit issued by banks in states without ceilings has grown sharply relative to credit issued by banks in states that still impose ceilings. Bank cards from states with mild usury ceilings have in turn proven more popular with consumers than cards from states with strict ceilings. The least successful bank credit cards have been those issued from states that impose strict "floating" ceilings similar to those in the proposed national controls.

This market evidence is a powerful contradiction to the argument that a national ceiling on credit card interest rates would be beneficial to consumers. Consumers can already choose between controlled and uncontrolled credit cards, and they are choosing uncontrolled cards in rapidly growing numbers -- so rapidly, in fact, that credit card credit has been growing more rapidly than any other form of consumer credit. A national interest rate ceiling would deny consumers this choice. At the same time, the ceiling would not restrict other forms of consumer credit, such as installment loans from retailers and finance companies, which are substitutable for credit card credit although usually more costly and less convenient. Under the proposed national ceilings, many individuals who currently use credit card credit would be deflected to these less desirable forms of financing.

The organization of the paper is as follows. Section 2 (page 6) provides background on the organization and operation of credit card services and the recent growth in credit card and other consumer credit. Section 3 (page 19) presents a brief discussion of the economics of price controls in monopoly and competitive markets; this section shows why and how price controls are economically harmful when imposed on firms in competitive markets. Section 4 (page 24) shows that the market for credit card credit is highly competitive and free of any plausible monopoly problems; that the level and pattern of credit card interest rates is a function of the costs and other aspects of supplying such credit; and that decontrolled card credit has been more successful with consumers than controlled credit during the recent period of free consumer choice and declining money market interest rates. Section 5 (page 53) shows that the proposed national ceilings on interest rates would force rates below market-clearing levels in many circumstances (such as the present), and describes the most likely economic consequences of the proposed ceilings.

2. Background

Devices called "credit cards" date back to early in the century. They were originally used by merchants simply to identify "regular customers," whose "credit" consisted of the right to be billed periodically for all purchases. But the modern, general purpose credit card is only about twenty years old, and would not have been possible before recent advances in data processing and communications technologies.[4] Over the past decade, credit cards have become a highly important -- and the fastest growing -- form of consumer finance in the United States.

a. How Credit Cards Operate

The defining characteristic of the modern credit card is its combination of "transaction features" with "credit features." Credit cards are widely accepted for numerous kinds of purchases in amounts running from a few dollars to several thousand dollars. In many respects cards are superior to checks or currency as a means of exchange -- for purchasing in foreign countries, for purchasing by mail or telephone, for maintaining records for tax and other purposes, and for minimizing the risk and financial cost of carrying large cash balances.

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[4] For a general account of the effects of technological and economic changes on the emergence of new forms of banking and finance, and the resulting erosion of traditional forms of financial regulation, see Alfred Broaddus, "Financial Innovation in the United States -- Background, Current Status and Prospects," Federal Reserve Board of Richmond, Economic Review (January/February 1985) 2.

At the same time, cards carry a pre-approved line of credit against which holders may borrow at will and repay largely at their own convenience. Thus, a consumer who receives a credit card is assigned an account and a line of credit (say, $1,000) by the card issuer, and may debit purchases to that account so long as the outstanding balance does not exceed the line of credit. The cardholder generally receives a monthly statement from the issuer showing all new charges; he may elect to pay the entire amount that month, to pay a "minimum" amount that month and the rest in minimum installments in future months (stretching up to several years), or to pay any intermediate amount at any time. Unlike many other forms of consumer lending, credit card credit is unsecured: if the cardholder defaults, the card issuer is without recourse against the goods purchased with the cards.

The most widely used form of credit card is the "bank card." Bank cards are issued by commercial banks (and increasingly by other depository institutions such as savings-and-loan associations and credit unions) to both depositors and non-depositors, in both national and local markets. A bank card may be used for purchases from any retailer whose bank is part of the card's system for settling interbank accounts. Thus a resident of Tulsa may carry a card from a local bank (or, for that matter, a card from a bank in Oklahoma City, Chicago, or anywhere else) and use it to make a purchase in Boston. The Boston seller will take the charge slip to his local bank and receive a deposit to his account; this deposit will then be debited to the cardholder's account at the issuing bank in Tulsa through the interbank settlements system. The cardholder will be billed for the purchase in his next monthly bank statement, and may choose to pay for the purchase within the month or "on credit" over a period of months or years. If the cardholder pays for the purchase on credit, his interest payments (as well as return of principal) will be earned by his Tulsa bank, which advanced its own funds for the purchase when it originally settled accounts with the seller's bank in Boston.

There are two primary systems for settling interbank accounts -- Visa and MasterCard. These organizations operate sophisticated, world-wide payments networks among "member" banks; the two systems settle over 1.5 billion bank card transactions annually (over 4 million transactions each day). The MasterCard and Visa settlement systems are similar to those operated by the Federal Reserve System and some private firms for other interbank settlements (such as checking account settlements), but they are "paperless" and in other respects more technologically advanced.[5] Visa and MasterCard also establish rules for the operation of the settlements systems, maintain systems of account numbering, operate point-of-sale authorization systems (for purchases over certain amounts), perform research (such as on anti-fraud technologies), and provide other services to member banks.

MasterCard and Visa do not, however, control the terms of service to cardholders and sellers. Each issuing bank determines (a) the level of its interest rates and annual fees to cardholders, (b) the level of its charges to sellers (which take the form of "merchant discounts" on deposits to sellers' accounts when retail charge receipts are presented), and (c) other means of financing the costs of supplying credit card services (such as the level of "late charges" on overdue accounts). In other words, MasterCard and Visa are suppliers of settlement, authorization, and related card services to banks (and other depository institutions), and banks are suppliers of credit card services (transaction and credit services) to consumers.[6]

Banks generally charge no interest on amounts paid in the month they are billed (the so-called "free period"), and after the first month charge monthly interest at annual rates which range from 12 to 21 percent but which are usually between 17 and 19 percent. Most banks charge an annual fee as well, typically about $15.[7]

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[5] See William F. Baxter, "Banking Interchange of Transactional Paper: Legal and Economic Perspectives," 26 J.L. & Econ. 541 (1983).

[6] Indeed Visa and MasterCard do not even collect data on interest rates and other card charges from member banks.

Over 15,000 depository institutions -- including over 75 percent of banks with assets between $50-100 million, and over 85 percent of larger banks -- offer MasterCard or Visa cards (usually both).[8] Of these, about 3,000 banks and other institutions are "issuing banks" and the rest are "participating banks." An "issuing bank" pays service fees to MasterCard or Visa for the services described above, and determines the interest rates, other fees, and service features of cards issued to cardholders;[9] it may issue cards either directly or in collaboration with a "participating bank." A "participating bank" may provide cards (usually bearing its own name) to cardholders, but purchases card services from an "issuing bank" and adopts the card features and charges of the issuing bank's card program. Thus the issuing banks are the relevant economic units for assessing concentration and competition in the supply of bank cards. Participating banks, however, are important "intermediate consumers" between issuing banks and many cardholders -- selecting among the card programs of numerous issuing banks according to their rates and service features.

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[7] American Bankers Association, 1984 Retail Bank Credit Report 73-4.

[8] Id. at 2, 62.

[9] In many cases "issuing banks" are in turn members of regional bank card associations and transact with MasterCard and Visa through these associations. Here as elsewhere we use the term "banks," for purposes of convenience, to refer to all forms of depository institutions that issue general purpose credit cards.

At the end of 1984, over 69 million Americans held one or more bank cards (1.9 cards per cardholder on average) and over 59 million card accounts were active monthly. Outstanding balances on bank card accounts totaled about $55 billion -- of which about $51 billion was on cards associated with the Visa and MasterCard systems.[10] Other than Visa and MasterCard cards, some banks issue their own "proprietary" cards in local markets (such as Citibank's "Choice" card in the mid-Atlantic states), and some independent firms issue credit cards through selected banks (such as American Express' "Gold Card"[11]). Local and proprietary cards are more likely to offer unique features such as variable or bracketed interest rates[12], rebate programs, and combinations of lower annual fees and higher interest rates or vice versa -- although many Visa and MasterCard programs offer these as well. For example, Citibank's Choice card features no annual fee and rebates for frequent users, while CoreStates Bank of Deleware offers a Visa account with a high annual fee ($50) but annual interest rates of 16.9 percent on monthly balances under $4,000 and 14.9 percent on larger monthly balances.[13]

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[10] Statistics from The Nilson Report, No. 347 (January 1985) 4-6. The Nilson Report is an independent bi-weekly newsletter covering developments in the credit card industry, which frequently presents statistics drawn from FRB collections and other sources. Its figures for transactions volumes and balances are generally accurate and are employed at various points in this paper. Its figures for total cardholders are rough approximations, however; administrative data collected by Visa and MasterCard suggest that over 80 million U.S. citizens currently have bank card accounts.

[11] The traditional American Express "Green Card" is not, strictly speaking, a credit card because it does not include a credit line -- all accounts are payable monthly. In industry parlance this is a "travel and entertainment card." Non-credit charge cards of this sort would not be directly affected by the credit card interest rate controls as currently proposed. But these cards do permit consumers to delay payment for purchases by between one and two months (depending on the time between purchase and billing). For this reason, outstanding charge card balances are properly included in assessing the amount and supplier shares of

The other major type of credit card is the "retail card" -- issued not by a bank but a retailer, and good for purchases and credit from that retailer only. There are more retail cards in circulation than bank cards (91 million Americans carried an average of 3.9 retail cards apiece at the end of 1984), but the average volume of transactions and credit is smaller, as one would expect; total outstanding balances were $46 billion at the end of 1984.[14] The most widely used retail cards are those issued by Sears, Montgomery Wards, and other large national retailers,

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11. (Cont'd.) total outstanding credit card credit, and we have done so in this paper.

[12] Variable rates are rates that fluctuate with changes in specified money market rates; bracketed rates are rates that are lower for accounts with larger credit balances.

[13] 1984 Retail Bank Credit Report, *supra* note 7; and "CoreStates Bank Offers Premium Visa Card with Lower Rate, Higher Fee," American Banker, July 11, 1985 at 16.

[14] The Nilson Report, *supra* note 10.

but numerous local and regional stores issue credit cards as well. In addition, most of the gasoline companies issue credit cards for purchases at service stations carrying their brands. Retail and gasoline card programs do not utilize interbank settlement systems (since all purchases are made from the same company that administers the consumer billing and credit services), but are otherwise similar to bank cards in operation and pricing.[15] Currently, several of the larger issuers of retail and gas cards (such as Sears and Shell Oil) are offering cards with expanded features comparable to those of bank cards, such as acceptability for purchases from sellers other than the card issuer, no annual service fee, and rebate programs.[16]

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15. There is, however, one important difference in pricing, which is an artifact of state usury controls and which works to the advantage of bank cards. Interest rates for retail and gas cards are subject to the usury ceilings of the cardholder's state, while rates for bank cards are subject to the ceilings of the card issuer's state. See Marquette National Bank v. First of Omaha Service Corp 439 U.S. 299 (1978); Donna C. Vandenbrink, "Usury Ceilings under DIDMCA," Federal Reserve Bank of Chicago, Economic Perspectives (September/October 1985) 25, 26. This means that a national retailer, such as Sears, must comply with an array of different state usury ceilings, some of them quite restrictive, while a national bank card issuer, such as Citicorp, may issue unregulated cards nationwide from a state with no interest rate ceilings. As we shall see, bank cards from regulation-free states have achieved the greatest success with consumers.

16. Constance Mitchell, "Card Wars: New Credit Contenders Offer Bargains to Lure Consumers," USA Today, September 9, 1985 at 12.

b. The Growth of Credit Card and Other Consumer Credit

Credit card credit is not, of course, the only form of consumer credit. Banks, credit unions, and savings-and-loan associations also provide credit -- including single-payment loans, installment loans, and revolving credit -- independent of credit card accounts. Finance companies provide direct personal and consumer loans, and retailers offer a variety of installment and "lay-away" purchase plans. The three major automobile manufacturers offer a substantial amount of credit for the purchase of new automobiles through their own finance companies.

Figure 1 on the following page illustrates the growth of credit card credit and other forms of consumer credit since the mid-1970s. The area labelled "Revolving" is a close approximation of credit card credit.[17] "Bank Installment" is installment loans (other than on bank card accounts) from banks and other depository institutions; "Retailer Installment" is installment sales other than on retail credit cards; "Finance Company" is personal and consumer-goods loans from finance companies; and "Non-Installment" is all

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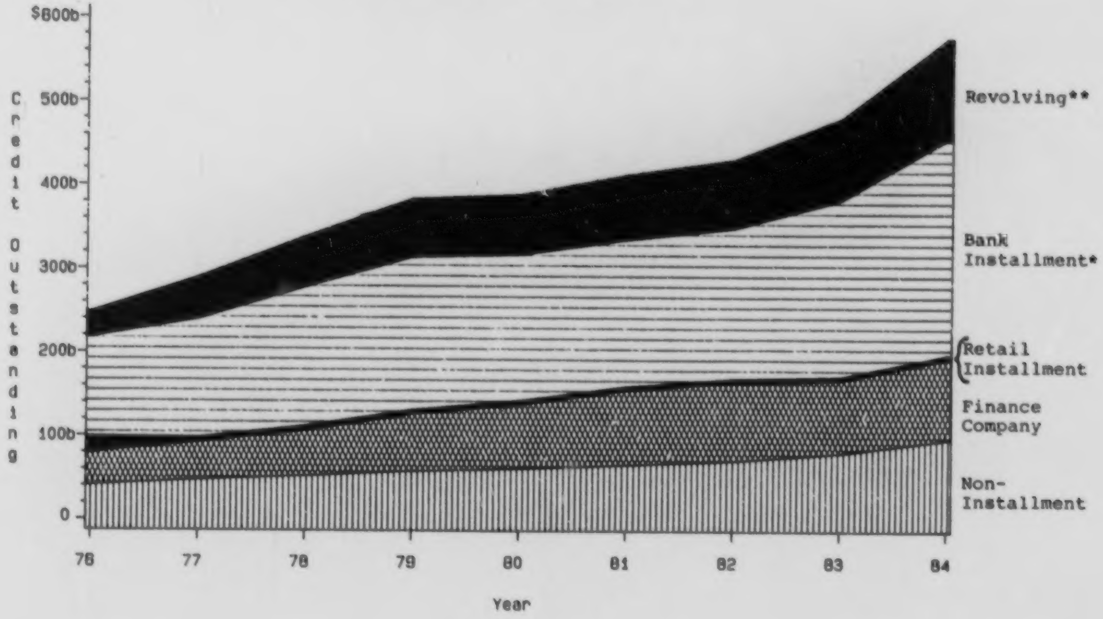
[17] "Revolving" consists of revolving installment credit issued by banks, retailers, and gasoline companies, plus that portion of noninstallment credit consisting of amounts due on charge accounts. The revolving credit component includes a small amount of revolving credit on bank checking accounts as well as credit card accounts, but omits credit card credit on accounts at depository institutions other than commercial banks, which has been growing rapidly in recent years. The charge account component includes balances in 30-day charge accounts such as "travel and entertainment card" accounts.

Figure 1

Growth in Consumer Credit Outstanding, 1976–1984
(Credit Outstanding in Billions of Dollars)



* Includes other depository institutions such as S&Ls, credit unions, and mutual savings banks.
** Total revolving credit from banks, retailers, and gasoline companies, plus balances outstanding on charge cards.

Source: Board of Governors of the Federal Reserve System single-payment loans other than those due in the first month on credit card and other charge accounts. "Revolving" -- primarily credit card -- credit has been the fastest growing form of consumer credit, but still accounted for only about 20% of outstanding consumer credit at the end of 1984 (about $118 billion of a total $577 billion outstanding).

The growth of credit card credit has reflected not only increased consumer spending in general but increased use of credit cards as a means of financing consumer purchases. The increase in card purchasing has in turn been due both to growing use per cardholder and a growing number of cardholders. As shown on Table 1 on the following page, credit card purchasing as a percentage of personal consumption expenditures (other than housing) grew 19 percent from 1980 through June 1985 -- from about 12.6 percent to 15 percent of expenditures. During the same period, the average outstanding balance on active Visa and MasterCard accounts increased 28 percent in real (inflation adjusted) dollars, while the average credit line on MasterCard accounts (Visa does not maintain comparable figures) increased 46 percent in real dollars. The number of active Visa and MasterCard accounts grew by 41 percent, far outstripping the 9-percent growth in the adult (20 years old and older) population.[18]

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[18] The portion of bank card purchasing paid for an extended credit with interest (i.e. the portion not paid before the end of the initial one-month "free period") remained constant throughout this period at about 50 percent of the total dollar volume of purchasing. The portion of bank card accounts paying interest on credit balances increased

Table 1

GROWTH OF BANK CARD CREDIT: 1980-85

	Credit Card Purchasing as a Percentage of Non-Housing Expenditures (All Cards)	Average Outstanding Balance per Active Account (Visa and MasterCard)	Number of Active Visa and MasterCard Accounts (millions)	Active Accounts as Percentage of Population Ages 20+ (Visa and MasterCard)	Average Line of Credit (MasterCard)
1985(2ndQ)	15.0 %	$653	68.9	41 %	$1496
1984	15.5	650	64.5	39	1457
1983	13.6	585	54.2	33	1314
1982	12.1	537	49.9	31	1084
1981	12.5	532	46.5	29	1035
1980	12.6	509	48.8	31	1028
Real Growth 1980-85(2ndQ)	+19 %	+28 %	+41 %	+29 %	+46 %

Sources: MasterCard International and Visa U.S.A.;
Federal Reserve Bulletin (various issues);
Statistical Abstract of U.S., 1985, Table 840;
Economic Report of the President, February 1985, 248-9, (Table B-14, B-20); The Wilson Report, June 1983, 4-5 and Jan. 1985, 4-5.

Notes: Dollar figures deflated to 1980 levels by Consumer Price Index.

Purchasing volume (column 1) derived on basis of data showing the ratio of outstanding balances to annual purchases is .4. This implies credit dollars are turned over 2.5 times per year. Outstanding balances in these calculations reflect the sum of revolving credit balances and charge card balances.

Two aspects of the growth in credit card use are particularly important to the analysis of this paper. The first is that the growth in accounts and in average balances per account has come at a time when prices, measured by interest rates on credit balances, have remained relatively constant (generally in the 17-19 percent range). This indicates a substantial increase in consumer demand for credit card credit, as well as an increased willingness by card issuers to extend credit -- both on an individual basis and to a larger share of the population of potential cardholders.

Second, the entire expansion in accounts has taken place since 1982; indeed the number of active accounts fell between 1979 and 1981, then increased at an annual rate of more than 9 percent after January 1982. The contraction in accounts occured during the period of very high interest rates in commercial money markets, which increased the costs of funds to card issuers; the recent expansion has coincided with a decline in the costs of funds (see Figure 4, page 37 infra). As the margin between credit card interest rates and commercial rates has grown, card issuers have expanded their demographic base -- issuing cards to population groups with higher credit risks. We shall return to these points in our discussion of credit card interest rates in Section 4.

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18. (Cont'd.) somewhat, from about 65 percent to about 70 percent. The use of extended credit on retail card accounts is apparently somewhat lower, about one-third of the dollar volume of purchasing. See discussion at pages 36-8 infra.

3. The Economics of Price Controls

Economists and other students of government regulation distinguish between price controls applied to monopoly firms and controls applied to competitive firms.[19] Firms in competitive markets cannot charge prices greater than their costs of supply, except in transitory circumstances or unless they collude on price. The reason for this is explained in detail in any good economics text,[20] but the essential logic is straightforward: (a) firms will continue to supply a product as long as the market price covers their costs of supply (including a competitive return on investment), and (b) if any individual firm attempts to charge a higher price, his customers will desert him for rival suppliers charging a lower price -- thus rewarding those who keep their prices at cost.

But a monopolist -- a firm that is the only supplier of a product for which consumers have no good substitutes -- is not under the same constraint. If he raises his price above cost, his customers cannot go elsewhere for the same product. Of course, any price increase will cause at least some consumers to purchase less of the product, so even a monopolist will find further price increases unprofitable at some point. In the typical case, however, the monopolist will be able to charge a price that exceeds his costs to some extent -- just how much depending on the strength of consumer demand for the product itself -- and thereby earn "supracompetitive" returns.[21]

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[19] See, for example, Stephen Breyer, Regulation and Its Reform (Harvard U. Press 1982) 15-23, 36-70, 240-260, 285-314; Alfred E. Kahn, The Economics of Regulation (John Wiley & Sons 1970); Richard A. Posner, Economic Analysis of Law, 2d ed., (Little, Brown and Co. 1977) 193-209, 251-270.

[20] Such as George J. Stigler, The Theory of Price, 3d ed., (Macmillian 1971) 176-191.

In monopoly markets, government price controls (such as those imposed by state public utility commissions on electric and telephone companies) can contribute to economic welfare, at least in theory. If the government prescribes a price that just covers the costs of supply, consumers will receive the benefit of the lower price, and output will not be restricted because the supplier will still cover his costs; indeed output will increase, because consumers will purchase more at the lower price. Thus, the very purpose of price regulation is to achieve the full economic benefits of competitive markets in cases where (usually because of economies of scale in production) a single firm can supply the entire market most efficiently.[22]

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[21] The "perfect monopoly" and the "perfectly competitive market" are of course paradigms, and firms may be able to charge prices greater than their costs in markets that are highly concentrated but less than perfect monopolies. See William M. Landes and Richard A. Posner, "Market Power in Antitrust Cases," 94 Harv. L. Rev. 937 (1981). But this is a detail for present purposes, since the degree of market concentration necessary for above-cost pricing is far greater than exists in the supply of credit card credit. See discussion at pages 25-35 infra.

[22] This is not to say that price regulation in monopoly markets actually achieves this purpose. It often does not,

When price ceilings are imposed on firms in competitive markets -- where prices approximate cost in the absence of controls -- and are set at below market-clearing levels, they will create a "gap" between supply and demand.[23] Consumers will demand more of the product than at the higher market price, but sellers will supply less -- either some sellers will be unable to stay in business at the controlled price, or all sellers will contract output to the point where their marginal costs of production fall to the level of the controlled price. But this is obviously an unstable situation, and both sellers and consumers will attempt to find ways to close the gap between supply and demand. With the most efficient means of doing so -- raising price until costs of supply and quantity of demand are equal -- foreclosed, there are only two ways this can be accomplished, each of them harmful to economic welfare.[24]

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22. (Cont'd.) primarily because of difficulties in making accurate determinations of costs of supply, and because even accurate cost-based regulation may distort the management incentives of regulated firms. See Kahn, supra note 19, and Richard A. Posner, "Natural Monopoly and Its Regulation," 21 Stan. L. Rev. 548 (1969).

[23] Where price ceilings are set above market-clearing levels they will have no economic effect at all, other than the wasted expenses of monitoring and administration. We ignore this case here.

[24] For a good technical accounts of the effects of price ceilings in credit markets, see James R. Ostas, "Effects of Usury Ceilings in the Mortgage Market," 31 J. Finance 821 (1976); and Donna Vandenbrink, "The Effects of Usury Ceilings," Federal Reserve Board of Chicago, Economic Perspectives (Midyear 1982) 44.

First, suppliers may attempt to meet the increased demand by raising their prices in ways that are not covered by the control program. The extent to which this is possible depends on the scope of the controls. For example, if interest rates on credit cards are set at below cost but annual fees are not controlled, issuers will raise their fees in an effort to meet their costs. To the extent such pricing responses are feasible, the price control program will be ineffective in reducing the actual prices faced by consumers. In fact, consumers will be worse off than before, since the new pricing system will be less efficient (more costly) than the one it replaced -- if the new pricing system were less costly it could and presumably would be introduced in the absence of the controls. Of course, it is always possible to attempt to expand the coverage of the price control program to take account of such responses, but the ways in which prices may be adjusted are almost always too various and subtle to be completely controlled. (One example, though not a subtle one, was "free toasters" for new bank depositors during the era of regulated rates on bank savings deposits). As we shall see, there are numerous repricing possibilities in the case of credit card credit.

Second, to the extent the price ceilings cannot be avoided through repricing, and thus are successful in reducing the effective prices of regulated suppliers, the result will be partial (or, in the extreme, total) withdrawal of service, for the simple reason that suppliers cannot continue in business at prices that fall below their costs. Withdrawal of service can take a variety of forms; conspicuous examples are the growth of unregulated suppliers of substitute products at the expense of regulated suppliers (money market funds before 1982), queues (gas lines during the petroleum price controls of the 1970s), and deterioration of service or product quality (railroads in the 1950s-1970s, rent controls in some cities today).[25] Where substitute, unregulated products are available, consumers will be worse off to the extent the substituted products are less desirable than the price-controlled products, in terms of price or quality or both. Where no good substitutes are available, the loss to consumers will take the form of poorer quality products and delays in obtaining them. (Delays are costly to consumers and thus may be thought of as a kind of price increase which even the most comprehensive control program cannot affect).

In either event, price controls are likely to impose not only the "deadweight" economic losses falling on all consumers and regulated suppliers, but also arbitrary redistributions of wealth and income among consumers and suppliers. For example, if suppliers have invested in assets that are specialized in the production of the controlled product or service, these suppliers will suffer windfall losses from the control program (the MasterCard and Visa interbank settlements facilities may be examples of such specialized assets). At the same time, firms that are positioned to supply unregulated substitutes (such as, perhaps, finance companies in the case of credit card controls) may enjoy windfall gains from the sudden increase in demand for their product. Similarly, controls usually result in differential gains and losses for different groups of consumers. Rent controls produce windfall gains for those who already have long-term apartment leases, and windfall losses for those who are just entering the apartment market; gasoline lines are more harmful to those whose time is more valuable. The amount and incidence of these windfalls will vary from case to case, but in a great number of instances -- including, as we shall see, the present one -- they are not only arbitrary but perverse: harming those who are less well off and those the price controls were ostensibly designed to protect.

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[25] A few examples of the many studies documenting these effects are Steven Breyer and Paul MacAvoy, "The Natural Gas Shortage and the Regulation of Natural Gas Producers," 86 Harv. L. Rev. 941; Thomas Gale Moore, Freight Transportation Regulation (American Enterprise Institute 1972); Joseph P. Kalt, The Economics and Politics of Oil Price Regulation (M.I.T Press 1982); and Andrew S. Carron and Paul W. MacAvoy, The Decline of Service in the Regulated Industries (American Enterprise Institute 1981).

4. The Supply of Credit Card Credit

As explained in the previous section, the essential step in determining whether price controls might contribute to economic welfare is to determine whether the market to be regulated is a monopoly (or at least highly concentrated), so that suppliers might have the power to charge prices exceeding costs in the absence of controls. In this section, we examine the market structure of the supply of credit card credit and recent patterns in the price (interest rates) and output of this and other kinds of lending. In addition, we investigate empirical evidence on recent trends in the supply of credit card credit from states with and without interest rate ceilings on such credit, which yields insights into the potential impact of national rate ceilings on credit supply.

a. The Structure of the Market

The supply of credit card credit by banks, retailers, and others is not concentrated at all -- indeed it approaches the textbook example of an "atomistic" market -- and is intensely competitive. The possibility of above-cost pricing in the setting of interest rates and other charges can therefore be confidently rejected. While existing data do not permit a precise calibration of market shares of individual card issuers (in part because there are so many of them), they do show that even the largest issuers possess only very small market shares. A detailed Federal Reserve Board study, such as that proposed in the Schumer bill, could no doubt generate more refined data than is currently available; but it is virtually certain that the conclusion of such a study would be identical to that presented here.

It is well to begin with the supply of credit card credit alone: although this is not, as we shall see, a separate market in economic terms, it is highly competitive even if one entirely ignores other forms of credit available to consumers. As shown on Figure 2 on the following page, the single largest credit card issuer, Sears, accounted for only about 11 percent of all credit card balances outstanding at the end of 1984; the second largest issuer, Citicorp (which issues Visa and MasterCard cards and several proprietary and regional cards) accounted for only 4 percent.[26] The largest ten issuers accounted for only about 34 percent of credit card credit. The largest 100 issuers accounted for about 66 percent, and the largest 300 accounted for about 78 percent.

These figures indicate that, even if credit card issuers faced no competition at all from other suppliers of consumer credit, they would be faced with a high degree of competition from each other -- more than enough to resolve concerns about excessive pricing. This may be seen by reference to the "Herfindahl-Hirshman Index" ("HHI") of market concentration, which is employed widely by economists

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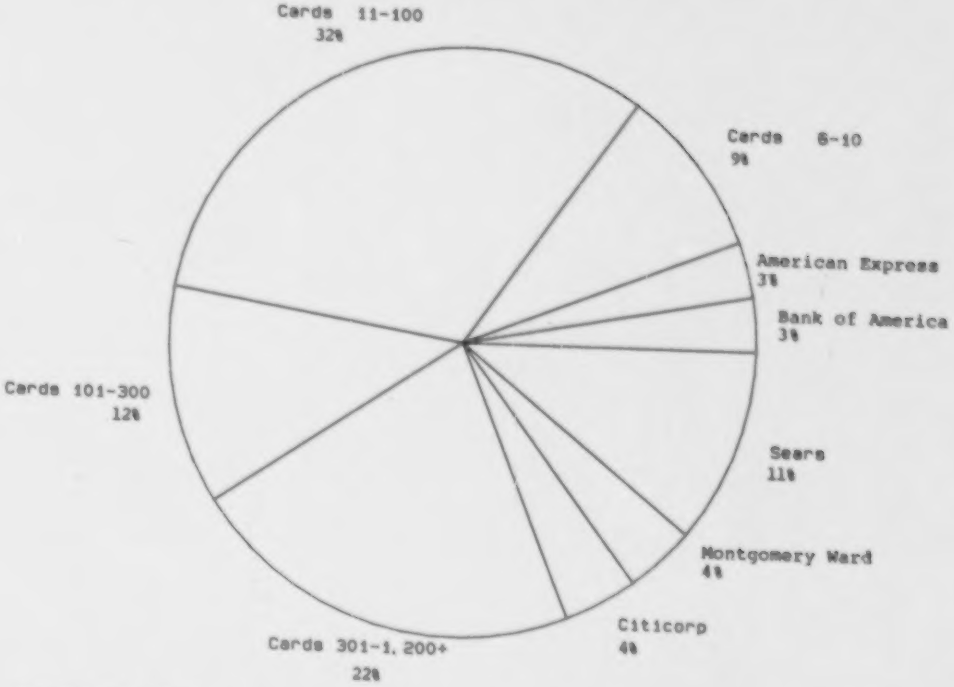
[26] Exact figures are presented in Table 2 on page 35, which includes data for other forms of consumer credit as well. The market-share data on Figure 2 and Table 2 includes not only outstanding balances on true credit cards that would be regulated by the proposed interest rate ceilings, but 30-day balances on "travel and entertainment" cards (such as American Express) and other charge cards lacking a credit line. The available firm-specific data are categorized in this way, and there is analytic merit in this approach as well, as explained earlier (see note 11 *supra*). American Express cards, which permit purchasers to delay paying for purchases by between one and two months, obviously compete with bank, retail, and gas cards. Omitting non-credit card balances would result in a very small increase in the shares of credit balances attributed to issuers of "true" credit cards.

Figure 2

Suppliers of Credit Card Credit, 1984
(Percent of Total Outstanding Credit Card Balances)



Source: See Table 2

and is used by the courts and the Department of Justice to measure concentration and competition under the antitrust laws. The HHI is calculated by squaring the market shares of individual firms and adding them together; thus, the HHI for a market with one firm is 10,000 (100^2), for a market with four firms of equal size is 2,500 (4×25^2), and for a market with ten equal firms is 1,000 (10×10^2). The Department of Justice considers markets with an HHI of less than 1,000 to be "unconcentrated," those with an HHI of 1,000 to 1,800 to be "moderately concentrated," and those with an HHI of over 1,800 to be "highly concentrated."[27] The market concentration for credit card supply is extremely low by this measure: even if credit card issuers were the *only* source of consumer credit in the U.S. economy, the HHI would be about *200-225*.[28]

This analysis assumes that the different types of credit cards compete with each other, and that the credit card market is nationwide rather than local. We assume it is self-evident that bank cards, retail cards, and gas cards compete directly with each other. Just as Sears, Roebuck competes with many other firms in the sale of retail merchandise, so the Sears card competes with bank cards in the sale of such merchandise on credit. Many, probably most, filling stations accept bank cards as well as those issued by their own suppliers. Moreover, even where credit cards are not substitutable as transaction devices (e.g., one generally cannot use a gas card to purchase other than automotive products on credit), the credit they supply is highly substitutable; this point is explained below in the discussion of competition between credit card and other consumer credit.

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[27] See U.S. Department of Justice, "Merger Guidelines and Accompanying Policy Statement," *Antitrust & Trade Reg. Rep.* (Special Supplement, June 14, 1982) ¶3. It should be emphasized that even "highly concentrated" markets may feature vigorous price competition, and there are many such markets in the U.S. economy; the Department merely uses these categories as guideposts to judge when mergers may lead to undue *increases* in concentration.

[28] The sum of squares of the "market" shares of the largest ten credit card issuers is 185, and the tenth issuer has a market share of 1.2 percent. Thus the maximum possible HHI for all credit card suppliers -- if all remaining issuers also had 1.2 percent shares and constituted, therefore, 55 firms -- is 264. But in fact there are hundreds of additional suppliers, only a few of which have shares exceeding 1 percent, so the HHI is probably only a little over 200.

It may be objected, however, that although many hundreds of large firms and thousands of smaller ones issue credit cards in the nation as a whole, a much smaller number of firms is likely to be serving any given locality -- local banks and retailers plus several national retailers, gasoline companies, and bank card issuers. This objection is substantially unfounded, for reasons explained below, but even if it were correct it would not alter the conclusion that the supply of credit card credit is highly competitive. Observe that all of the ten largest card suppliers issue card credits nationally -- so that a citizen of (say) Washington D.C. may obtain a card from J.C. Penney and Sears as well as Hechingers and other local merchants, and from Citicorp (issuing from South Dakota), Chase Manhattan (issuing from Delaware), and Bank of America (issuing from California) as well as from Riggs Bank and other local banks. Since the ten largest firms compete in all local markets, as do many smaller national and regional banks, savings-and-loans, credit unions, and retailers, local markets remain highly competitive. For example, even if a local market was served only by the largest ten national firms plus ten other card suppliers (all of about equal shares), the HHI would still be only about 600.

But as an economic matter the market for credit card credit is in fact the national market. The purpose of analyzing market concentration is to understand pricing behavior. One wants to know whether, if one firm set prices higher than costs of supply, other firms would be in a position take business away from that firm, so that the higher price would be unprofitable. For this reason, one includes in a "relevant market" not only the firms currently serving it, but also those who would serve it if existing firms raised their prices. If a small town has only one insurance salesman, the salesman is not a "monopolist," even if everyone in town purchases insurance only from him; if he charges excessive prices, other salesmen can easily expand their territories to include the town, or townspeople can purchase their insurance from distant carriers by mail or telephone.

Thus, any local credit card market should include not only those issuers serving it at any one time, but additional issuers who could easily enter if the existing firms raised their rates above competitive levels. The number of such potential entrants is not the universe of all U.S. card issuers -- because, ironically, state usury laws make it unprofitable for many banks to seek out-of-state customers for their cards[29] -- but it is very large. The non-regulatory costs of entering a new territory are the costs of postage and supplies for a solicitation campaign, and new bank and retail cards routinely enter new regional markets far afield of their bases of operation. Indeed the emergence of nationwide credit cards is one of the most important recent developments making the provision of financial services far more competitive than it was in the past.[30]

While the supply of credit card credit is itself highly competitive, it also competes with numerous other forms of consumer credit -- that supplied by finance companies and that supplied directly by retailers, manufacturers, and depository institutions that do not offer credit car programs. In many cases the substitutability of such other forms of credit is direct and obvious; for example, one may purchase a new kitchen appliance or stereo system not only with credit card credit but with a loan from a finance company or on direct credit from the retailer. But the potential for substitution is much broader than this -- and includes forms of credit available only for items not purchased with credit cards -- because credit itself is highly fungible.

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[29] Some supporters of national credit card controls have complained that cards issued by banks in states with strict usury ceilings are not available in other states. But the reason such cards are not widely available is that it is unprofitable for banks subject to interest rate controls to issue them widely. Banks in states with low usury ceilings generally limit cards to preferred local customers who are known to them as good credit risks; banks in uncontrolled states are much more likely to issue cards nationwide. This point is discussed in detail in the last part of this section.

[30] See Lee Loevinger, "Antitrust and the Banking Revolution," 9 Regulation (July/August 1985) 12.

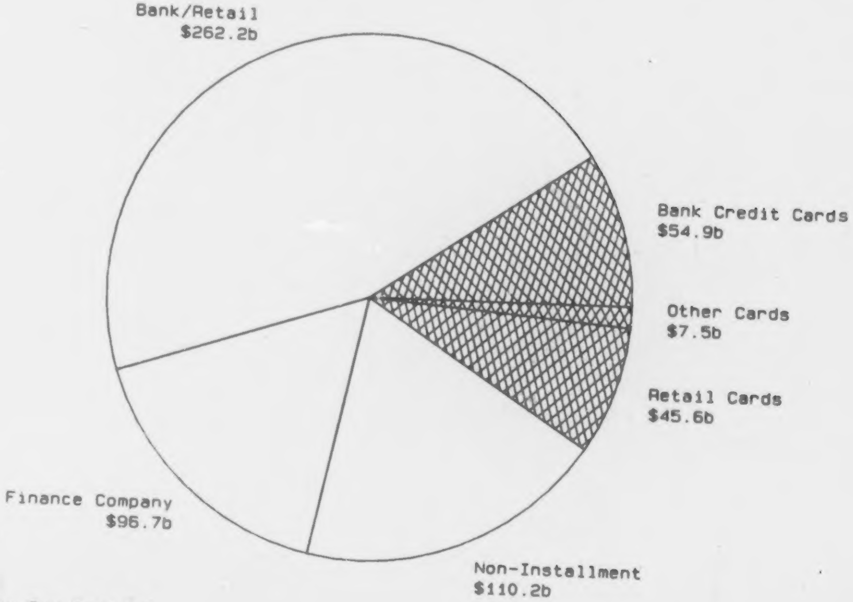
To see this, imagine that interest rates for credit card credit were set at excessive (above-cost) levels, but that rates on loans for purchasing new automobiles were competitive. Although automobiles are not ordinarily purchased with credit cards, automobile credit would nonetheless substitute for credit card credit: consumers would tend to purchase automobiles more extensively on credit, and other goods less extensively with credit card credit. Of course not all consumers would do this, but many certainly would. Virtually all consumer products (other than the smallest items) can be purchased on credit, yet only about 15 percent of purchasing is in fact made on credit card credit (see Table 1, supra page 17). This means that consumers have ample opportunities for shifting their "debt portfolios" from one category of spending to another in response to different "prices" for different categories of credit. The result is that the interest rate on one bank's credit card is constrained by rates for automobile credit in about the same way as it is constrained by rates on other credit cards. As a practical matter even home mortgages are highly substitutable for credit card credit, although we have not included mortgage borrowing in our analysis.

Figure 3 on the following page gives an approximation of the shares of consumer credit in 1984 offered by credit card issuers and other credit issuers; further detail is presented on Table 2 on the next page. According to these figures (which are slightly different than those used to construct Figure 1, supra page 15, because they are derived from a different source which includes data by card issuer), all credit card credit combined accounted for only 19 percent of outstanding consumer credit in 1984. It is not possible to estimate market shares or an HHI for the entire consumer credit market, because this would require combining card credit and non-card credit for banks and, in many cases, retailers, and the data to do this are not available. Such an exercise would tell us no more than we already know: market concentration in the supply of consumer credit, and the market shares of even the largest suppliers of credit cards, are vanishingly small.

Figure 3

Credit Card Credit and Total Consumer Credit, 1984
(Credit Outstanding in Billions of Dollars)

Total Credit Outstanding = $577.1 Billion



Source: See Table 2.

Table 2

CREDIT CARD CREDIT AND OTHER CONSUMER CREDIT, 1984

	Amount outstanding (billions)	% of credit-card credit	% of consumer credit
1. All consumer credit	$577.1		100.0 %
2. Credit card credit	108.0	100.0 %	18.7
a. Bank card credit	54.9	50.8	9.5
b. Retail card credit	45.6	42.2	7.9
c. Gas and other card credit	7.5	6.9	1.3
3. Credit card issuers			
a. Ten largest issuers	$ 36.8	34.0 %	6.4 %
Sears	11.6	10.7	2.0
Citicorp	4.4	4.1	0.8
Montgomery Ward	4.2	3.9	0.7
Bank of America	3.3	3.1	0.6
American Express	3.2	3.0	0.6
J.C. Penney	3.2	3.0	0.6
First of Chicago	2.3	2.1	0.4
Chemical Bank	1.6	1.5	0.3
Chase Manhattan	1.6	1.5	0.3
Manufacturers Bank	1.3	1.2	0.2
b. Top 100 issuers (estimate)	$ 71	66 %	12 %
c. Top 300 issuers (estimate)	$ 84	78 %	15 %

Source: Federal Reserve Bulletin, September 1985, Table 1.55 (p.A40); The Nilson Report, No. 347 (Jan. 1985) 4-5, No. 339 (Sept. 1984) 6-7, No. 338 (Aug. 1984) 4-5, No. 337 (Aug. 1984) 4-5.

Note: Estimates for top 100 and top 300 card issuers derived by taking sums of published outstanding balances for top 100 and 300 bank cards in 1983 and extrapolating to incorporate 1983-4 growth and non-bank credit card balances.

b. Credit Card Interest Rates

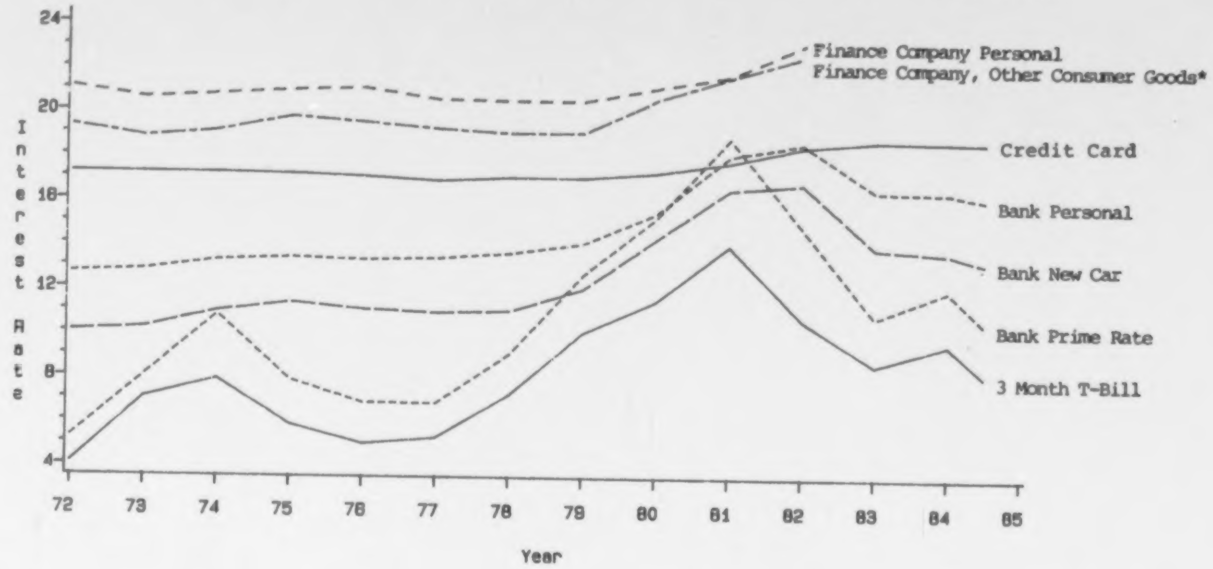
The rate of interest on credit card credit, as measured by the Federal Reserve Board's calculations of national average rates, has remained quite constant at about 18 percent since credit cards came into widespread circulation in the early 1970s. This is shown on Figure 4 on the following page. Credit card interest rates have generally been somewhat higher and steadier than rates for other forms of consumer installment credit (secured and unsecured) available from commercial banks, but lower than rates for both secured and unsecured loans from finance companies (which were also quite stable throughout the period). Aggregate data on retail (non-card) installment credit are unavailable.

Figure 4 also displays the prime rate and percentage yields on 3-month Treasury bills for this period. These rates are considerably more volatile than rates for credit card and other consumer credit; indeed the prime rate was higher than that on credit card credit for a period in 1980 and 1981. The yield on 3-month T-bills would be the reference rate for determining interest rate ceilings under one of the proposed credit card laws. The reference rates in the other bills, 6-month T-bills rates and Federal Reserve discount rates, are generally very close to those on 3-month T-bills.

Interest rates paid by credit card borrowers are actually somewhat lower than the nominal rates, since most card issuers charge no interest during the initial one-month

Figure 4

Annual Movements in Consumer and Money Market Interest Rates, 1972–1985



Source: Board of Governors of the Federal Reserve System.

Notes: Beginning in 1980 48–month new car rates are used instead of 36–month, and 24–month personal loan rates instead of 12–month. The finance company series were discontinued after 1982.

- Other Consumer Goods (excludes autos and mobile homes).

"free period," and many cardholders pay their entire balances during this period. According to bank card statistics compiled by MasterCard and Visa, about 30 percent of all card accounts are paid monthly, without incurring any interest charge. Cardholders who use their cards purely as a transaction device tend use their cards more intensively (making more or larger purchases), however, so that about 50 percent of the dollar volume of credit card purchases are paid without incurring any interest. Credit dollars loaned earn interest for roughly five months on average, which suggests that 5/6 of all outstanding balances are earning interest at any point in time. Thus, an average nominal interest rate of 18 percent translates to an average effective interest rate of about 15 percent.

That credit card interest rates are higher than rates in commercial money markets is to be expected. The cost of providing credit card credit is only in part the cost of funds to the issuer. According to the Federal Reserve Board's most recent "functional cost analysis" of selected commercial banks, only 42 percent of the total costs of providing bank card services consisted of costs of funds in 1984.[30] While accounting cost calculations such as those use by the FRB are subject to numerous technical difficulties, the role of processing, debt-collection, and other administrative costs in the provision of consumer credit is well understood: these costs vary only slightly with the amount of the loan (the costs of processing a $500 loan are little different from those of a $2,000 loan), so interest rates (price as a percentage of the amount of the loan) must be higher for smaller loans in order to cover costs.[31]

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[30] Federal Reserve Board, Functional Cost Analysis, 1984 Average Banks (1985) 38. The cost structure of retail card credit is apparently similar: J.C. Penney's Annual Report for 1984 reports that costs of funds accounted for 50 percent of its costs of providing consumer credit.

That credit card interest rates are higher than rates on some other forms of consumer credit is also to the expected. Credit card credit is distinctive in many ways which affect its costs of provision. It is often extended in small amounts; it can be drawn upon without advanced notice at point-of-sale, with instant authorization from the lender for larger purchases; it can be repaid on highly flexible terms; it is made available to large and heterogeneous populations; it is unsecured. For example, bank installment loans often include individual credit investigations which are charged to the borrower as a flat fee, and which result in a credit portfolio that is of lower risk (and therefore lower cost) to the bank than the portfolio of credit card credit. Finance company loans also involve credit investigations, but are generally extended in smaller amounts and to a riskier group of borrowers than bank loans; the administrative costs per dollar of loan are presumably higher than those for either bank installment of credit card loans. Automobile loans are highly secured, often approximating leases. One would expect, then, that interest rates on credit card credit would be considerably higher than the costs of commercial credit, would fluctuate less, and would be different (sometimes higher and sometimes lower) than rates for some other kinds of consumer credit.

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[31] See Richard L. Peterson, "Pricing Consumer Loans and Deposits," in Richard C. Aspinwall and Robert A. Eisenbeis, ed., Handbook for Banking Strategy (John Wiley & Sons 1985) 549.

Nor should it be cause for concern that credit card interest rates have generally not declined with the decline in commercial money market rates since 1981. To begin with, the stability of card rates is no indicator of "market power" on the part of card issuers, even apart from the evidence of competitive supply presented in the first part of this section. The monopolist, or other firm with market power to charge prices greater than costs, charges prices that maximize his profits -- which are a function of costs of supply and the strength of market demand. If a monopolist's costs fall, so does his profit maximizing price. So even if all credit card credit were supplied by a single firm, and consumers had no alternative sources of credit, this would not explain any of the divergence between the commercial costs of money and credit card interest rates since 1981.

The recent stability of credit card rates takes on a different light, of course, when viewed over the longer perspective of 1972 through 1985, as on Figure 4. One might as well ask why card rates were not much lower in the mid-1970s than they are today, or why they did not rise to over 25 percent in 1981. A number of plausible explanations have been offered for the recent stability of credit card rates -- such as the long-term structure of the cost of funds to banks and other large organizations, deposit interest rate deregulation, bankers' expectations that commercial rates would begin to rise sharply, and the higher costs of raising than lowering rates under "rate increase notification" regulations.[32] But surely an important part of the explanation lies in the development and growth of the credit card market and the distortions of state usury laws.

To explain, the credit card market was developing rapidly throughout the 1970s. Card issuers were accumulating large numbers of new cardholder accounts, and most states controlled interest rates through their traditional usury laws (before 1979 only two states, California and New Hampshire, did not control credit card rates, and most state ceilings were set at about 18 percent). Then, in the early 1980s, the steep rise in money market rates generally made credit card programs unprofitable, since rates generally could not be increased. Partially as a result, most states relaxed or repealed their usury laws (at least as they applied to credit cards) between 1979 and 1982 (see note 3 *supra*). This gave many card issuers the pricing flexibility they previously lacked, but concurrently money market rates began to decline, while the demand for credit cards apparently increased. The result was that interest rates -- prices per dollar volume of credit -- neither rose nor fell; instead, card issuers greatly expanded the *amount* of credit they made available to individual cardholders and solicited new accounts, such as from college students and recent graduates, who were riskier (and therefore costlier) than those who had received cards earlier.

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[32] See Helen J. Scott, "Interest Rates on Consumer and Commercial Loans: Why the Difference?," Congressional Research Service, Library of Congress, Report 85-818 E (May 17, 1985); Statement of Robert W. Johnson, Subcommittee on Consumer Affairs and Coinage, Committee on Banking, Finance and Urban Affairs, United States House of Representatives, Hearings on H.R. 1197 and H.R. 3408 (October 29, 1985). One explanation that is not at all plausible, however, is this one: "some consumer groups felt that banks overdid their claim to increased costs and did not reduce consumer rates in order to finance overseas loans and absorb expected large losses on these investments." Scott, op. cit. at 29. A bank or other firm cannot recoup losses in market A by raising prices in market B, regardless of whether it is a "perfect competitor" or "perfect monopolist." Assuming the firm was doing the best it could in market B before the reversals in market A, a price increase in market B will lose it money.

This account is strongly suggested by the data presented earlier on Table 1 (*supra* page 15). In 1981 and 1982, when money market rates were very high and the wave of state usury deregulation was just underway, average bank card balances and the number of bank card accounts were growing very slowly or declining; afterwards, as rate deregulation took effect and costs (at least that portion of total costs associated with costs of funds) declined, both accounts and average balances (as well as credit lines) grew dramatically.

This explanation, like the others mentioned above, is necessarily based on short-run suppositions, as any explanation of current pricing trends must be. The explanation has the virtue, however, of being consistent with economic theory and the available facts. The recent pattern of output is precisely the opposite of what one would expect if the assumptions underlying the proposed interest rate ceilings were accurate -- that is, if card issuers had been freely providing bargain credit in the early 1980s while "gouging" more recently. But it is perfectly consistent with the operation of competitive markets for firms, faced with declining costs but growing demand, to expand output and improve product quality (which is what offering larger credit lines consists of) at a constant market price.

The recent pattern may or may not persist in the future. As many observers have noted, a number of major banks, such as Manufacturers Hanover Trust and CoreStates, have recently announced substantial reductions in interest rates on their card programs. The reductions may prove unprofitable, or may auger the end of the recent period of increasing demand and expanding credit service. One can only speculate whether it will be one or the other -- but one can say with confidence that the result will be determined by the decisions of suppliers and consumers in a highly diverse and competitive credit card market.

c. The Pattern of Credit Card Growth Across States

The pattern of credit card credit across states in recent years provides further evidence of competition in the credit card market and the potential effects of national interest rate controls. As explained earlier, interest rates on bank cards are subject to the usury laws of the card issuer's state rather than the cardholder's state (see note 15 supra). This legal regime, combined with the recent wave of usury deregulation and the fact that card programs can be administered at low cost in interstate markets, means that consumers have a wide degree of choice between various "regulated" and "unregulated" bank cards. At present, 16 states maintain "strict" interest rate controls over credit card credit (ceilings of 18 percent or lower), 17 states plus the District of Columbia maintain "moderate" controls (ceilings of higher than 18 percent), and 16 states have no controls.[33] As a result, a resident of Louisiana may obtain a credit card from a local bank, subject to that state's interest rate ceiling of 18 percent, or a card from banks in California, South Dakota, or Illinois (or other "free states"), which are subject to no rate controls and which actively solicit card accounts nationally. The Louisiana resident might also obtain a card from banks in neighboring states which impose controls looser and stricter than his own state; for example, Alabama's ceiling is 21 percent on the first $750 of credit and 18 percent on higher balances, while Arkansas' ceiling -- similar to the national ceiling proposed in the Biaggi bill -- is the lower of 17 percent or 5 percentage points over the Federal Reserve discount rate. In these cases, the Louisiana resident's choice may be limited by the business judgment of banks in the nearby states not to solicit out-of-state accounts. But to the extent this is so, it results from the state interest rate restrictions themselves, rather than from any inherent legal or economic limitations on interstate provision of credit card credit.

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[33] Data supplied by Office of the General Counsel, American Bankers Association. The breakdown used in the analysis later in this section is slightly different, dividing states into "strict," "moderate," and "no control" categories as of the end of 1982.

This state of affairs makes it possible to investigate with some precision the recent growth in credit card credit and the proposition that interest rate ceilings benefit consumers when issuers' costs of funds are declining. Since the recent wave of state usury deregulation was followed by a steep decline in money market interest rates (as shown on Figure 4, supra page 37), card credit provided by banks in states that retained interest rate ceilings should have grown relatively faster than unregulated bank card credit -- if it is correct that interest rate ceilings are beneficial to consumers. On the other hand, if the supply of bank card credit is competitive, and usury ceilings injure consumers by contracting credit availability, then unregulated credit should have grown more rapidly than regulated credit.[34]

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[34] Divergent trends in state bank card credit would fail to test the desirability of usury controls only if consumers (a) were generally unaware of bank card interest rates and (b) tended as a group to choose regulated or unregulated

The evidence demonstrates that the second proposition is correct: unregulated bank cards have done far better with consumers than regulated cards. As shown on Table 3 on the following page, revolving credit issued by banks in states with no credit card interest controls has been growing more than twice as fast as credit from banks in states with moderate and strict rate controls. In all, credit from "no control" states grew 14 percent as a portion of national revolving bank credit from 1980 through the end of 1984, while credit from "moderate control" states fell 20 percent and credit from "strict control" states fell 14 percent.

Data on revolving bank credit is, as explained earlier (at note 17 *supra*), only an approximation of bank card credit -- it includes balances on check revolving credit accounts, but omits balances on cards issued by depository institutions other than banks. Table 4 (page 48) therefore presents similar calculations, derived from data maintained by Visa U.S.A., for credit on Visa cards by state. The

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34. (Cont'd.) cards for some fortuitous or inexplicable reason. But federal law requires detailed and frequent disclosure of credit card and other consumer credit interest rates, and surveys show that cardholders are generally highly knowledgeable concerning card interest rates, even more so than for other forms of credit. See Statement of Robert W. Johnson, *supra* note 32, at 12. In addition, "participating banks" serve as intermediate consumers in many cases (see discussion at page 10-11 *supra*) and will have detailed knowledge of the rates charged by various issuing banks. But even if cardholders were ignorant of interest rates and unregulated banks were able to fool consumers into accepting excessively high rates, this would not explain the growth of unregulated cards relative to regulated cards documented in the text.

Table 3

GROWTH IN BANK REVOLVING CREDIT, BY STATE GROUPS, 1980-1984

	Real Growth, 1980-84	Share of U.S. Revolving Credit		
		1980	1984	% Change
States with No Interest Rate Controls	83.5%	54.9%	62.5%	13.8%
States with Moderate Interest Rate Controls	30.5%	21.5%	17.3%	-19.5%
States with Strict Interest Rate Controls	39.7%	23.6%	20.2%	-14.4%
(Arkansas	-4.8%	.17%	.10%	-41.2%)
All States	62.7%	100.0%	100.0%	

Source: Federal Reserve Board, Consumer Price Index, and *The AECS Review* No. 247-48 (June-July 1985) 18-19 (Table 6).

Note: "No control" states are AZ, CA, DE, IL, MT, NH, NJ, NM, NV, NY, OR, SC, SD, VA.

"Moderate control" states are AL, CO, DC, IA, ID, IN, KS, KY, MA, MD, ME, MS, OH, OK, RI, TN, TX, WI, WY.

"Strict control" states are AK, AR, CT, FL, GA, HI, LA, MI, MN, MO, NC, ND, NE, PA, UT, VT, WA, WV.

Breakdown is as of August 1982. Subsequently, three additional states (IA, ID, and NE) abolished rate controls on credit cards and one additional state (UT) relaxed its controls from 18 percent to a higher ceiling.

Table 4

GROWTH IN VISA CARD CREDIT, BY STATE GROUPS, 1980-1985

	Real Growth, 1980-85(2dQ)	Share of U.S. Revolving Credit		
		1980	1985	% Change
States with No Interest Rate Controls	135.0%	57.3%	62.0%	13.4%
States with Moderate Interest Rate Controls	81.8%	19.7%	17.3%	-12.2%
States with Strict Interest Rate Controls	58.4%	23.0%	17.7%	-23.0%
(Arkansas	11.3%	.23%	.10%	-47.8%)
All States	106.5%	100.0 %	100.0 %	

Source: Visa U.S.A. and Consumer Price Index.

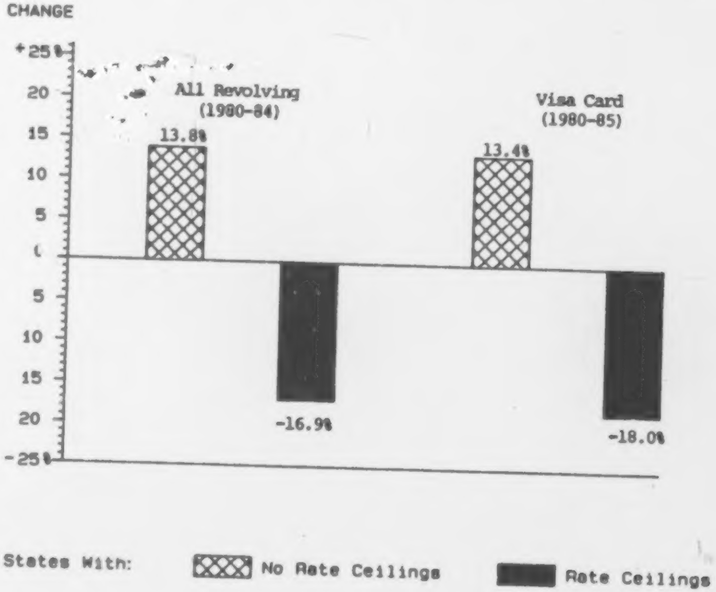
Note: State breakdown same as on Table 3.

results are very similar. Visa cards issued by banks and other depository institutions in "no control" states grew at a far higher rate than those issued from states with interest rate controls, and increased their share of national credit on Visa cards by over 13 percent between 1980 and mid-1985. During the same period, cards issued from states with moderate rate controls fell 12 percent as a share of national credit on Visa cards, and cards from states with strict controls fell 23 percent. The revolving bank credit and Visa card credit results are summarized graphically on Figure 5 on the following page, which displays the relative growth in unregulated credit and relative decline in credit subject to rate controls.

Tables 3 and 4 include a separate breakout for the State of Arkansas, which has the state usury program most like those in the national proposals (as explained above), and which has often been offered as a model by proponents of national rate controls. Arkansas did far worse even than other "strict control" states, and was near the bottom of all states in all comparisons. Revolving credit issued by Arkansas banks actually declined in real terms between 1980 and the end of 1984; only Kentucky banks did worse. Visa card credit issued by Arkansas banks grew only slightly, 11 percent over a period of 4 1/2 years. This was less than anywhere else in the nation except for two states where Visa credit declined in real terms: Louisiana, which has a flat 18-percent usury ceiling, and Alaska -- the only other state

Figure 5

Changes In State Shares of Credit Card Credit, 1980–1984/85



Source: Federal Reserve Board and Visa U.S.A.

with a "floating" usury ceiling similar to those in the proposed national ceilings.

This market evidence is unambiguous: as money market rates have fallen, unregulated card credit has become increasingly more successful with consumers than credit subject to interest rate ceilings. Card credit subject to moderate ceilings has in turn been more successful than credit subject to strict ceilings, and card credit subject to strict "floating" ceilings has been least successful of all.

This is not to say, of course, that consumers prefer higher interest rates (or other prices) to lower ones, other things being equal. To the contrary, it is because consumers prefer lower prices that we know other things must not be equal in the present case.[35] The relative success of unregulated cards must be due to their superior quality, measured by both service features and availability. Banks from states with no usury controls appear to be the most aggressive marketers of bank cards -- offering a variety of different cards with features appealing to different groups of consumers, advertising their cards nationwide, and soliciting new cardholders among riskier demographic groups such as students, individuals of modest means, individuals with no credit history, etc. Banks from states with strict controls, on the other hand, appear to be highly restrictive in issuing cards -- limiting them, for example, to longstanding local depositors and executives with firms that do business with the bank.

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[35] Actual interest payments may not vary that much from state to state, however, which strenghthens our conclusions. Interest rates may not be much different between unregulated bank cards and those subject to moderate controls; notice that the recent rate reductions, such as those announced by CoreStates and Manufacturers Hanover, appear to be primarily by banks whose card interest rates are not regulated. Even where rate differences are substantial (as between unregulated cards and those in the strictest control states) the absolute difference in finance charges paid by cardholders may not be large.

Some evidence of this is presented on Table 5 on the following page, showing the "credit charge-off rate" (i.e., the percentage of credit volume written off as bad debt) for Visa cards in our three categories of states. While the charge-off rate is quite low in all states, it is substantially higher in states without interest rate controls than in states with controls. This indicates that unregulated bank card programs are much more likely to take business risks in order to supply cards to a greater number of consumers, and that regulated programs are more likely to restrict access to well-known customers. The charge-off rate for banks in states with the tightest ceilings (approximating those in the proposed national laws) approaches zero (in 1984 it was .43 percent for Arkansas and .07 percent for Alaska) -- suggesting that banks operating under these conditions can afford to provide credit only to a very few select individuals.

Table 5

VISA CHARGE-OFFS AS PERCENT OF TOTAL PURCHASES, BY STATE GROUPS, 1984

States With No Interest Rate Controls	1.38 %
States With Moderate Interest Rate Controls	.89 %
States With Strict Interest Rate Controls	.85 %
All States	1.18 %

Source: Visa U.S.A.

Note: Charge-off data are for bad debt only and do not include charge-offs for fraud.

State breakdown same as on Table 3.

5. The Effects of a National Interest Rate Ceiling

The national interest rate ceilings currently under consideration in the Congress, which would float at 5 or 6 percentage points above rates in commercial money markets, would be seriously binding on credit card credit in many circumstances. For example, during the period charted on Figure 4 (supra page 37) such ceilings would have forced interest rates to below market levels for ten of the thirteen years shown (excluding the period from 1979-82). The current ceiling rate would be in the 12-13 percent range -- about that currently charged for secured loans on new automobiles. This is more than one-third lower than the current average market rate for credit card interest, and lower than rates in all but a few states, where card credit is severely restricted.

Notice that one could not select a "better" average ceiling -- say one that was "too tight" just about as often as it was "too loose" -- and expect that the two kinds of errors would cancel out in the long run. The economic consequences of the binding ceilings in the "too tight" years could not be compensated for in the "too loose" years, since market competition would keep rates at cost whenever the floating ceiling was above market levels. Even in monopoly markets, price controls that are set too low and too high do not compensate, since the output of the regulated firm is restricted in both cases.

The first effect of a binding national rate ceiling would be an increase in the demand for credit cards and a decrease in their supply. Card issuers would attempt to adjust to the increased demand by increasing their prices in ways not covered by the national controls. One obvious alternative would be to raise annual fees. Others would be to eliminate the initial "free period" on card accounts and, in the case of bank cards, to increase the merchant discount (the fee charged to retailers against their credit card sales).

The national controls could be, of course, expanded to cover these aspects of credit pricing, and in fact a few states already control cardholder fees, free periods, and merchant discounts. There would, however, be numerous additional repricing opportunities that would be much more difficult to monitor or control. Card issuers could revise their procedures for clearing and posting card charges so as to initiate both the free and interest periods earlier; could establish new or additional charges for initial credit checks, account inquiries, and late payments; and could require some or all applicants to purchase credit insurance at their own expense (as is often done for non-card consumer loans). Sears, Roebuck and other retailers could raised product prices to all customers (about half of Sears purchases are made on its credit card), or raise prices on those products most frequently purchased on credit. Such changes in product prices would be economically equivalent to an increase in the merchant discount on bank cards, but would be far more difficult to monitor and control, and presumably would be considered beyond the appropriate scope of an interest rate scheme.

Pricing adjustments such as these would have different effects on different cardholders and card issuers, but their net effect on economic welfare would be negative. For example, it seems likely that Sears and other large retail card issuers would be in a better position than independent retailers to reprice products in response to interest rate controls -- because, as just mentioned, there is no independent market transaction (the bank card merchant discount) to be monitored and controlled in the case of retail cards. For this reason and others (see discussion at note 15 supra), national credit card controls would probably be less harmful to retail cards than to banks cards.[36] For another example, consider that some cardholders (such as frequent borrowers) would prefer cards with higher annual fees and lower interest rates, such as national rate controls would probably promote.

In both cases, however, consumers as a whole would be worse off, even though some would do better than others. Consumers do not gain when one group of sellers (large national retailers) gains an advantage over another group (smaller retailers) solely because of a superior ability to adjust to price controls. Some widely marketed bank cards already offer higher annual fees and lower interest rates (see note 13 _supra_), so consumers who prefer this option can obtain it with or without rate ceilings; consumers who prefer lower fees and higher rates, however, could not obtain their own preferred option with rate ceilings. The general point is straightforward: pricing systems adopted solely in response to government controls on one aspect of price are certain to be less efficient, and to have arbitrary distributive effects among different groups of suppliers and consumers.

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[36] Indeed it is conceivable, though unlikely, that large national retailers would be net beneficiaries of national interest rate controls, by gaining market shares from smaller retailers who currently rely on bank cards and from bank card issuers who are currently freer of state usury controls than retail cards.

Although one can envision numerous possibilities for repricing credit card services, it is unlikely that such adjustments could close the gap between demand and supply created by a binding national rate ceiling. This conclusion is suggested by the evidence presented in the previous section on bank card growth in states with different usury policies. If credit cards could be _completely_ repriced in response to usury ceilings, cards issued from controlled states could replicate the prices of uncontrolled cards and one would expect to see no systematic pattern between card credit from the two groups of states. That one instead sees a considerable divergence -- even between uncontrolled states and states with "moderate" ceilings only slightly below market interest rates -- suggests that the opportunities for repricing are not very substantial as a practical matter. Either the inefficiencies of repricing are greater than the benefits (a pricing change may increase revenues x percent per account but lose more than x percent of accounts), or there are important competitive restraints on repricing (competition from charge cards such as American Express may restrict the ability of bank cards to eliminate their "free periods," for example).[37]

It is likely, therefore, that national rate controls would produce the more serious economic effects suggested in Section 3 -- a contraction in the availability of credit card credit, partially compensated by the expansion of other forms of credit which are more costly or less convenient (or both) but are unregulated. The contraction of card credit can be expected to be similar to that which has already occurred in states with strict rate ceilings. Depending on the stringency of the national controls, bank card issuers would withdraw from marketing card services on a nationwide basis, would withdraw from marketing to riskier demographic

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37. This is not to say that that issuers cannot reprice at all. There is recent evidence, for example, that Arkansas banks tie the sale of consumer loans more closely to other, deposit services, and charge higher service and overdraft fees on deposit accounts, than banks in states with no usury restrictions. A. Charlene Sullivan, "Evidence of the Effect of Restrictive Loan Rate Ceilings on Prices of Consumer Financial Services," Working Paper No. 36, Credit Research Service, Krannert Graduate School of Management, Purdue University (hereafter Credit Research Center) (1980). The point, rather, is that opportunities for repricing are sufficiently limited that national interest rate controls are likely to produce other, non-price responses.

groups such as students and individuals with lower incomes, or would restrict their card programs to preferred customers such as longstanding depositors and executives of client firms. All of these actions could, and in one way and another would, close any gap between supply and demand remaining after feasible repricing opportunities had been exhausted; they would do so by reducing the costs of supplying credit card credit and increasing the costs of obtaining it.

In the case of the state interest rate ceilings examined in Section 4, the relative decline in credit from controlled states probably had little effect on total outstanding card credit nationally or even in the controlled states -- since such a large amount of card credit was readily available from uncontrolled states. But under a binding national rate ceiling this response will be impossible, so the resulting decline (relative or absolute) in credit card credit will be made up, where possible, by growth in other kinds of consumer credit. Consumer credit is highly substitutable, for reasons explained in Section 4, and studies of state usury controls have shown that even very broad controls often have little effect on the total amount of credit used by consumers.[38] Thus, an obvious means of contraction for card issuers will be to tighten their credit standards in an effort to issue credit to fewer and more credit-worthy cardholders. Those who cannot qualify for credit under the new standards may go to finance companies for larger purchases and attempt to arrange direct retail loans for smaller purchases. Even where loans are unavailable for kinds of purchases currently financed through credit cards (such as for meals, air transportation, and other travel expenses) credit may be effectively substituted by drawing larger loans for other purposes (such as auto loans, or second-mortgage credit lines at banks) and paying for a larger share of personal expenses in cash.

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[38] For example, even when Arkansas maintained a comprehensive 10-percent interest rate ceiling, it appeared to have little effect on the total amount of credit used by consumers in the state. Consumers relied much more heavily on direct retail credit (where retailers could offer loans at the usury ceiling and finance the true cost of the loans by raising product prices), and less heavily on other forms of credit than consumers in other states. Richard L.

Studies of usury controls have devoted a great deal of attention to the possible distributive effects of interest rate controls, especially as between poorer and better-off consumers.[39] It is easy to imagine that these effects may be regressive, both in general and in the case of the national credit card proposals. Less affluent cardholders

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38. (Cont'd.) Peterson, "Effect of a Restrictive Usury Law on the Consumer Credit Market," Credit Research Center (1981). On the other hand, when Massachusetts dropped its usury ceiling selectively on small loans, the effect was a substantial drop in the small loans outstanding in the state. Robert W. Johnson and A. Charlene Sullivan, "Restrictive Effects of Rate Ceilings on Consumer Choice: The Massachusetts Experience," Working Paper No. 35, Credit Research Center (1980). Presumably this was because borrowers of small amounts lacked good substitutes (generally only finance companies among legitimate firms make small loans), or because they were able to increase marginally their debt on larger purchases.

[39] See studies discussed in Vandenbrink, *supra* note 24.

would probably be the first to be screened out by a restriction in credit card credit through application of tighter credit standards; if, lacking a bank line or a home eligible for a second mortgage, their next best alternative is a finance company personal loan, they are likely to pay considerably higher interest rates than they did when credit card credit was unregulated. The total redistributive effects of national rate ceiling would highly arbitrary and unpredictable. As a general proposition, however, individuals of modest means are likely to fair relatively better when the available credit is allocated by market prices than when it is allocated according to administrative judgments, credit records, and use of other financial services.

When consumers (of whatever income bracket) are deflected to other forms of borrowing, they will be worse off even when the explicit interest rate for the substitute credit is no higher, or is lower, than for credit card credit. Probably the most distinctive attribute of credit card credit is its convenience and link to cards' transactions features. Many consumers could reduce their total interest payments at present by drawing larger loans on cars or homes and carrying larger amounts of cash on hand; they do not because the small difference in cost is well worth the added convenience. So they would be worse off under credit card controls even if the total amount of credit they used remained unchanged and even if the amount of interest they paid declined.

A final effect of national rate controls would be increased segmentation of credit markets, both by type and by geography. Currently, credit card programs combine large and diverse pools of borrowers with different alternative borrowing opportunities -- and therefore compete with many different forms of consumer credit. Interest rate controls would reduce competition between types of credit because card issuers would tend to specialize in lower credit risks, leaving higher risks to a smaller set of remaining sources such as finance companies and smaller retailers. This effect has already been observed in some credit markets under state usury ceilings.[40] There is probably sufficient competion within credit categories (that is, between competing finance companies, between competing bank cards etc.,) that the effect of this segmentation on competition and interest rates levels would be small in the aggregate. In certain circumstances, however, the effect would be substantial: the wide availability of bank cards probably places a substantial constraint on the ability of smaller retailers to discriminate in rates among credit customers according to the intensity of their purchasing desires and their alternative borrowing opportunities.

Another type of segmentation would be more serious. The emergence of numerous national bank cards, especially following the wave of state usury deregulation in the early 1980s, has probably had a substantial effect in making credit markets more competitive, especially in smaller communities. If national interest rate controls had results similar to those already observed in states that maintain strict controls over bank card rates -- the withdrawal of card programs to exclusively state and local markets -- the benefits of this increased competition in the provision of consumer credit would be lost.

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[40] A. Charlene Sullivan, "Effects of Consumer Loan Rate Ceilings on Competition Between Banks and Finance Companies," Working Paper No. 38, Credit Research Center (1981).

Chairman **Annunzio**. Thank you for appearing today.

Our next witness is Dr. Robert W. Johnson, director of the Credit Research Center.

Mr. **Hiler**. If I might interject at this point to welcome Dr. Johnson, a fellow Hoosier.

It is nice to have you in Washington to testify on a subject which you are eminently qualified to testify on.

I would like to thank the chairman for his willingness to grant the request of the honorable ranking member of the full committee and myself in having you appear today.

We appreciate your trek from West Lafayette.

STATEMENT OF ROBERT W. JOHNSON, DIRECTOR, CREDIT RESEARCH CENTER, KRANNERT GRADUATE SCHOOL OF MANAGEMENT, PURDUE UNIVERSITY, WEST LAFAYETTE, IN

Mr. **Johnson**. Thank you. Any movement out of West Lafayette is indeed a trek.

As indicated, I am the director of the Credit Research Center. This is a nonprofit organization, part of the Krannert Graduate School of Management at Purdue University.

We were formed in 1974. During the first 5 years we were supported—50 percent of our budget—by Government agencies. Government agencies are not quite as flexible with funds these days, so we are supported by unrestricted grants from a very broad section of industry, ranging from credit unions to credit reporting agencies, and across the board.

I do not purport to represent the views of industry or particular consumer groups, and I appear as an independent witness. These are my views from 30 years of experience in the credit area.

I will summarize my testimony, since many of the points have been made.

Basically, what I want to talk about is whether indeed there is a need for the rate ceiling, and most importantly, how that rate ceiling will affect consumers.

With respect to the evidence produced in the charts over there, let me suggest we really can't compare prime rates and the credit card rates or compare 3-month Treasury bills to credit card rates because those are all short-term sources of funds.

If we look at the evidence, first of all, a fairly small portion of the cost of providing revolving credit is not in the cost of money; it is in the operating cost.

The latest functional cost analysis shows that for large banks, about 40 percent of their total cost is cost of funds. For smaller banks, about 36 percent. For retailers, cost of funds seems to be around 50 percent, although we don't have any recent studies.

More importantly, the cost of funds is not a function of short-term rates. More and more lenders are going into long-term money markets to match the long maturities that are the effective maturities on a credit card portfolio.

Over the period, 1980 to 1984, the J.C. Penney Co. has obtained about 83 percent of their funds in the long-term market. Indeed, the cost of money for J.C. Penney has gone up from 9.9 percent in 1980 to 11 percent in 1984, the latest fiscal period. Therefore, their total costs are very slightly effected by changes in short-term money rates.

Now, it is true that if you look at the charts over there, we find that the great stability, indeed a slight increase in the rates on bank cards, which are the only data for which we have good information, and certainly one of the reasons is that the consumers are not particularly sensitive to the rate.

I don't think this is because consumers are uninformed or unsophisticated, or as in one of the press releases, laziness and ignorance substitutes for good judgment.

If we look at a transaction, let's say $100. We are talking about small amounts of credit; the average outstanding in bank card accounts—again, from the functional of cost analysis—is $500. So you are a consumer contemplating the purchase of a $100 item from some particular retailer, and the retailer, let's say, has a charge of 18 percent on that item. As you repay that loan over 12 months, your total finance charge is going to end up $10.

Now, you can shop for a lower rate, you might get a lower rate of 16 percent. That means you would have to change retailers, you would have to buy maybe a radio or whatever it is you are buying that is a little less desirable, and for all that effort you are going to save 2 percentage points, about $1 out of the $10.

Why should you spend a lot of effort to save $1 over 12 months in order to get a lower APR?

Consumers are not necessarily lazy, they value their time, and considering that the addition to the total cash price provided by the credit finance charge is not much more than the sales tax of New York State, why spend all that time looking around for a slightly better rate?

One of the other points that was not brought out was one of the reasons creditors don't bring down their rates is because it is very difficult to reverse and raise their rates at a later date.

If you look at the Federal budget, as Ms. Seger pointed out, and you look ahead and if you think interest rates are going to rise, particularly long-term interest rates, which are your major source of funds, what would you do? Would you cut rates today?

If you were in Iowa, what you would have to do to reverse course 6 months from now would be to send out to all your credit card holders in Iowa, whether they are active or inactive, two notices. Those two notices must arrive at the consumer's residence not less than three billing cycles prior to the time that you want to change the rate. That is a costly process and you are going to be waiting 6 months or so to make a rate change.

So one of the oddities of today's world is that in an effort to protect consumers, some States have required such a delay in the opportunity to change your mind, once you have cut your rates, that it hampers your motives to cut rates.

In addition, other States require that you have to hold the old balances to one side, apply the old rates to that and only the new balances are subject to the increased rates. So we have legislation that gets in the way of rate flexibility.

Now turning to whether or not the credit markets are competitive.

I think that has been discussed at some length. I would point out we have rate disclosure, that in fact the latest Federal study for which we have information, the 1977 national survey, shows that 71 percent of the consumers were aware of the rates they were paying on their bank cards and 65 percent of the consumers holding retail cards were aware. Contrast that to 38 percent who were aware on used car rates.

I would agree with Mr. Fox there is merit both on the part of Congress and the Fed looking into rate disclosure on pre-approved applications.

If we turn again to the marketplace and say, what evidence is there that the rate is competitive, the only point that I would add to that is, let's look at what people don't do. Why don't retailers put on an annual fee? Don't you suppose there is competition preventing retailers from putting on an annual fee?

Why don't retailers charge from the date of posting? Don't you think it is competition that prevents that kind of action on the part of retailers?

A suggestion is made that no nation has ever succeeded without interest rate controls. The English abolished interest rate ceilings in 1815. I would regard England as a fairly successful nation, and they haven't reimposed interest rate controls on consumer credit.

The only thing English law says, if a rate gets around 80 percent, it is prima facie unconscionable. Anything below that is unconscionable and unless you can prove otherwise. It is a different kind of life, I guess.

Let me turn finally to what Ms. Seger commented on, the undesirable side effects.

The supposition is that if you roll back interest rates, we are going to save the consumer, you name it, somewhere between $2 million, $4 billion. Let's see if that is true or not.

We have, I think, a competitive market. Let's say you put the ceiling on bank cards and force the rates down to, say, 14 percent or 13 percent. What would you do as a banker faced with that situation?

Your income is being drastically cut, so what do you have to do? You must find other sources of income or reduce your cost.

Where would you find other sources of income? One thing you would do is eliminate the free period, charge from the date of posting. What wouldn't you do? You might raise the annual fee, but again I would agree with Mr. Fox; I think consumers are fairly sensitive to the annual fee and it would be difficult to raise it.

What are you most likely to do? I think you are most likely to raise the merchant discount rate. Instead of giving the merchant $98 for a $100 sales slip, you give him $96.

We found banks in Arkansas offering credit cards, and their APR was 10 percent. But the merchant discount in Arkansas was 5.5 percent compared to 2 percent in Illinois and 3.6 percent in Louisiana.

What does that do for the consumers? You just saved them $4 billion in their credit charges. But what happens to the cash prices?

Obviously, the retailer who is paying a higher merchant discount faces competition. He has to pass that on in the higher form of a higher cash price. And who pays the higher cash price? The people who aren't eligible to have credit cards as well as the credit card holders.

But you are asking the less affluent consumer who can't get credit cards to subsidize the credit purchasers of the affluent consumer.

And we might also look upon what happens to the small retailers. Congress has for some time expressed concern over the small businessman. Credit card rates are set on the basis of the volume the retailer produces and the average balance on the sales slip.

Small retailers don't create much volume, so the smaller retailer is the one who is going to be hit hardest. So you are impinging not only on the low-income consumer, but the small retailer.

On the cost side, what is the banker going to do? The banker, if you were a banker, would say, let's raise credit standards. We want to reduce the cost of collection.

If you look at any scoring system, we can tell who is going to be cut out of the market. It is the consumer with low income, who is young, short time on the job, short time at his residence, a renter rather than an owner, or a more elderly person who doesn't have a steady source of income necessarily or may not have a job and may have just moved into a retirement community and doesn't have the points necessary to obtain a card. These are the people that will pay the price of the savings, so called, of reducing the rates.

I don't regard that as a very satisfactory tradeoff.

Now, finally, in the case of retail cards, what happens? Well, you are forcing the retailer, as again we found and earlier studies have found in Arkansas, you are forcing the retailer to raise cash prices.

Early on, studies discovered that if you looked at the same refrigerator, the same model number, it was selling for more in Arkansas than the surrounding States. Once again you are asking the cash buyer to subsidize the credit buyer.

I also might say I applaud the research suggested by Representative Schumer, but that is because I always applaud research. I think we need to look harder at what the ultimate effect will be on the consumer, and question whether or not the savings that are being proposed aren't being paid for by those consumers who are least able to afford the subsidization of those savings.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Johnson follows:]

STATEMENT OF ROBERT W. JOHNSON, DIRECTOR, CREDIT RESEARCH CENTER, KRANNERT GRADUATE SCHOOL OF MANAGEMENT, PURDUE UNIVERSITY, WEST LAFAYETTE, IN

Mr. Chairman and members of the Committee, my name is Robert W. Johnson, Director of the Credit Research Center, Purdue University. The Credit Research Center (CRC) is a nonprofit research organization that was established in 1974 as a part of the Krannert Graduate School of Management, Purdue University. Our primary function is to undertake and disseminate research in the field of consumer credit and mortgage credit. Over the first five years of our existence, about half of our financial support came from various government agencies and about half from unrestricted grants from a broad cross-section of the credit industry. Recently, we have relied more heavily on unrestricted grants from a very diverse industry group.

I am appearing at your invitation to present research findings relevant to your consideration of H.R.1197 and H.R.3408. We are pleased to share with you the research that bears on the complex issues raised by these two bills.

My discussion is divided into two main parts. First, I examine the issue of whether a rate ceiling on credit cards is needed, and, then, I trace the potential effects of a such rate ceiling on consumers.

IS THERE A NEED FOR A RATE CEILINGS ON CREDIT CARDS?

To judge the need for a rate ceiling on credit cards, we need first to examine the evidence that has led to the concerns expressed about the level of rates on credit cards. Essentially, is there a problem in the first place? Next, data indicate very clearly that average credit card rates have been rising slowly since 1977. What factors explain this seeming rigidity in the prices of this type of credit? Among the potential explanations is a lack of competition in the credit card market--an issue explored in the third part of this section.

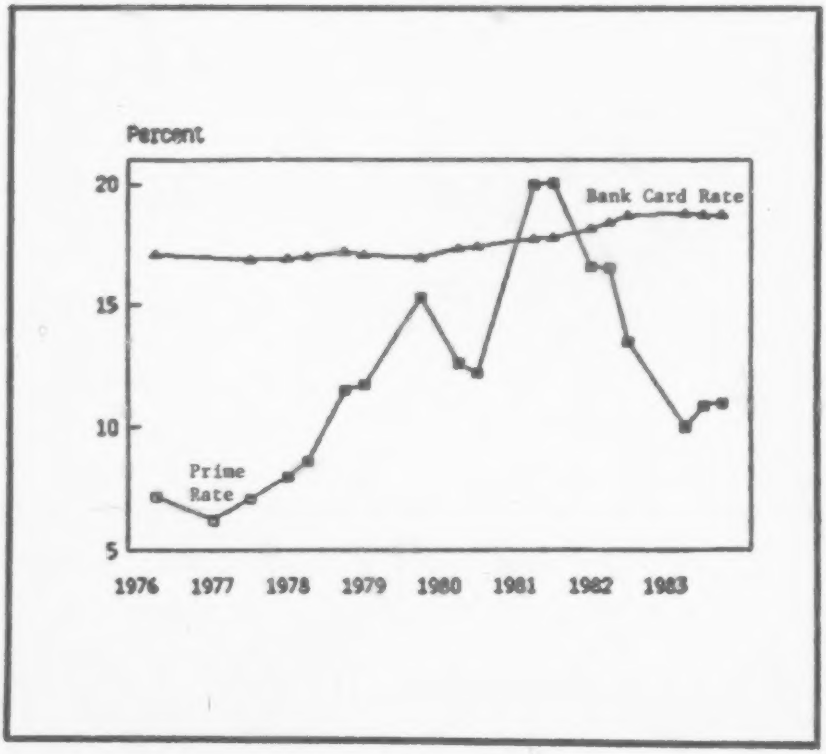
Does the Evidence Indicate a Problem?

Many articles in the news media have created a crisis environment by tracing the relationship of average rates on bank credit cards to prime rates over the period from 1980 or 1981 to the present. A casual observation of the sharp decline in the prime rate and the very gradual rise in bank credit card rates in that period might suggest that something is wrong and needs legislative fixing. However, this evidence is faulty for at least the two following reasons.

Selection of the base year is misleading. Deleting all information prior to 1980 conceals the fact that 1981 was a odd year in many ways, not the least of which was the very high prime rate that prevailed in that year. If we disclose the relationship of bank card rates to prime rates for earlier years, the distortion introduced by viewing only the period after 1980 is apparent. As we can see in Exhibit 1, if we examine the entire period since 1977, we can find no significant relationship between bank card rates and prime rates. The spread of bank card rates over prime has varied from 9.37 percent in October 1977 to a negative 2.72 percent in August 1981 to 9.12 percent in August 1985. If no alarms were sounded in 1977, why should they ring now?

Exhibit 1

CREDIT CARD RATES AND PRIME RATE



Credit card rates and prime rates are not properly comparable. Why don't we find a relationship between the prime rate and bank card and retail card rates? Presumably, a comparison is attempted because of a belief that prime rates somehow express the costs to banks and retailers of providing revolving credit. This is not the case. The cost of funds represents only a portion of the total costs of revolving credit, and the prime rate does not adequately represent the cost of funds used by banks and retailers to finance their accounts receivable.

In total, the cost of funds is only about half of the total costs of providing revolving credit. Data from the most recent Functional Cost Analysis of the Federal Reserve System show that the cost of funds comprised only 36 percent of total costs of medium-sized card-issuing banks and 40 percent of total costs of large-sized card-issuing banks. The most recent study that we have of retailers' credit card costs is that by Shay and Dunkelberg of retailers in New York for the fiscal year ending January 1973. At that time retailers' cost of funds amounted to 40 percent of total costs of credit. According to the latest annual report for J.C. Penney Co., its cost of funds comprised 50 percent of its total costs of providing consumers credit.

Furthermore, creditors' total cost of funds over time bears little relationship to the prime rate. While the prime rate is the rate that banks charge their most creditworthy business customers on short-term loans, firms providing consumer credit rely heavily on long-term borrowings to finance those receivables. A matching of the maturities of accounts receivable and sources of funds is a sensible way of avoiding the interest-rate risk.

As illustration of this practice, the long-term debt of the J.C. Penney Co. has averaged about 83 percent of total borrowings over the past five years and its average borrowing rate has climbed from 9.9 percent in 1980 to 11.0 percent in 1984.

	1980	1981	1982	1983	1984
Long-term debt as percentage of total borrowings, net of short-term investments	80.8	98.0	80.6	77.6	78.7
Average borrowing rate(%)	9.9	9.8	10.4	10.2	11.0

Proxies for the prime rate are equally unsatisfactory indices of credit costs. Just as the prime is not an acceptable indicator of credit costs over time, the discount rate on 90-day commercial paper at Federal Reserve banks and yields on three-month treasury bills suffer from the same deficiencies as indices of credit costs. Both are measures of the cost of short-term money, as in the case of the prime rate. While their fluctuations over time closely mimic movements in the prime rate, they bear little or no relationship to the total costs of providing bank or retail revolving credit.

Summary Points

**1. The evidence submitted to support rate ceilings on credit cards is faulty for two reasons:

a. Data showing the relationship of bank card rates to prime rates are often provided only for 1980 and following years. But 1981 was a peak year for the prime rate.

b. The prime rate bears little relationship to the costs of providing revolving credit.

**2. Since the prime rate is not an acceptable indicator of credit costs, neither are the rates on 90-day commercial paper rate and three-month treasury bills.

Does the stability of credit card rates indicate a problem?

Credit cards provide more than credit services. It is inappropriate to consider the monthly finance charges on bank and retail credit cards as solely for the use of credit. A cardholder receives three basic services. First, there is a significant convenience factor acquired by a cardholder. For example, a consumer carrying a bank credit card can make a series of purchases of goods and services at different locations during a month and then receive and pay a single bill on which each seller is identified. Thus, what we observe to be a credit purchase may be a cash purchase to the consumer. In fact members of the staff of the Federal Reserve Board have estimated that half of the outstandings on bank credit cards should be viewed as the product of cash, rather than credit, transactions.

In addition, a cardholder obtains a standby line of credit. In the business world, a corporate borrower might pay a large sum for a standby line of credit. But it is just one of the services provided consumers who hold credit cards for which no specific charge is made.

The cost to the bank or retailer of providing these services does not vary directly with the creditors' cost of funds. A large portion of total operating costs is generated by providing convenience to consumers and facilitating a standby line of credit. Since these operating costs are relatively fixed, regardless of the amount of credit used, we would not expect the subsequent price of credit to vary with the cost of funds.

Consumers are relatively insensitive to the quoted APR on revolving credit. Although research shows that consumers are very much aware of the APRs charged on credit cards, they continue to use larger and larger amounts of revolving credit in spite of the rising rates we have seen. Of course, one reason they are willing to pay higher rates is that they are buying more than credit services, as observed in the previous section.

Another reason is that many consumers do not pay the APRs quoted. Under most systems for assessing finance charges, they avoid paying these rates, so long as they pay the bill in full. They are "nonrevolvers." They are taking advantage of the "free period" offered on most bank and retail credit card accounts. Because the free period is built into most systems of assessing finance charges, the actual yield to creditors from their credit card portfolio is less than the APR quoted to consumers. A study published by CRC shows that under the frequently used "modified" average daily balance method the actual gross yield for a sample of retailers would have been about 84 percent of the APR quoted under truth-in-lending for a sample of retailers and 83 percent for a sample of banks. Thus, if the quoted rate on a bank card is 19 percent, the actual realized yield to an average bank using this system of assessing charges would be about 15 3/4 percent.

Consumers are also not highly sensitive to the APR because the finance charge does not comprise a large portion of the total time price of goods and services purchased on credit. ("Time price" is the sum of the cash price and the finance charge, or the sum of the required monthly payments.) Assume, for example, that a consumer buys a $400 TV set on her credit card, for which she is assessed 1 1/2 percent per month, for a disclosed APR of 18 percent. If the debt is paid off by 12 monthly payments, the time price of the TV set would be $440.06; that is 12 x $36.67. The dollar amount of the finance charge would be $40.06: the time price less the cash price [$440.06 - $400.00].Thus, the finance charge ($40.06) would amount to only 9.1 percent of the time price ($440.06), not much more than the sales tax in some areas. It is not surprising that consumers spend more effort shopping for the TV set than for the credit to finance it.

Legislation impedes rate decreases. Put yourself in the position of a banker or retailer who is contemplating reducing credit card rates. Perhaps you also believe that within a year long-term interest rates will be increasing and so will your cost of funds. How easy will it be for you to reverse course and increase your credit card rates?

While you need not make an advance disclosure to cardholders if you drop your rate, Federal disclosure legislation requires that you notify all customers 15 days prior to the effective date of any rate increase of the impending change. This notice must go to all your accounts, many of whom may be inactive, but still cardholders.

But, if you operate a bank or store in Iowa you must send out two notices and they must be mailed three billing cycles in advance of the change. Thus, in addition to the cost of sending the two notices, you must wait for perhaps four or five months before you can reflect your higher cost of funds in your finance charges. In five other states (Indiana, Kansas, Montana, Oklahoma, and Wyoming) you must send two notices two billing cycles in advance of the increase in rates. Further, in a number of states, you must hold separate the "old" balances and the "new" balances reflecting purchases made after the rate increase. You must then apply the old rate to the old balances until they are eliminated and the new rate only to the new balances. If you were a the credit manager of a small bank or retailer, would you cut your credit card rates at this point?

Another reason that rates may not have fallen is the continuing losses that credit grantors are experiencing from consumer bankruptcies. The legislation enacted in 1978 resulted in an increase of 2.6 times in consumer bankruptcies and has apparently left us with a permanently higher bankruptcy rate. Since issuers of credit cards are unsecured creditors, they seldom realize any recovery on the debts owed by consumer bankrupts. Thus, they must factor into their finance charge a higher cost factor in 1985 than was necessary in 1977.

Summary Points

**1. Because credit cards provide more services to consumers than just the use of credit, it is inappropriate to compare credit card rates with other interest rates (such as the prime rate) which are almost entirely for the use of credit.

**2. Consumers are relatively insensitive to the quoted APR on credit cards, in part because they receive convenience and a line of credit and in part because the total finance charges make up only a small portion of the time price of goods and services purchased.

**3. Because Federal and State legislation makes it costly to increase rates, issuers of credit cards are hesitant to cut rates if they anticipate an increase in their cost of funds.

**4. A continued high level of consumer bankruptcies will lead to higher credit card rates than would have prevailed had bankruptcies been less accessible.

Are Credit Card Markets Competitive?

As indicated in H.R.3408, a critical issue in any discussion of price ceilings is whether the market involved is competitive. To assess whether the market for credit cards is competitive, we shall examine the adequacy of the pricing system and the evidence of what happens and doesn't happen in the marketplace.

Rate disclosure appears to be effective. In the consumer credit area a uniform system for pricing credit was established in 1968 under the principle, as ennunciated in one of the hearings, that consumers "should be able to shop for credit just as they shop for meat and potatoes." Once effective price comparisons are possible, we should be able to assign control of prices of meat, potatoes and credit to the marketplace rather than to the legislature.

Because cardholders are reminded of the APR on their accounts on a monthly basis, it is not surprising to find a high level of awareness of credit card APRs. Three major national surveys of consumers from 1979 to 1977 have revealed increasing awareness of finance rates by consumers. (Consumers were deemed to be "aware" if their estimates of the APRs on credit that they used fell within an "awareness zone;" that is, a range within which market rates might reasonably have fallen). The 1977 Consumer Credit Survey showed that about 71 percent of bank cardholders were aware of the APR and about 65 percent of retail cardholders were aware. In contrast, only 38.3 percent of consumers buying used automobiles were aware of the APRs they had paid.

Evidence from the marketplace indicates effective competition. The high levels of awareness of credit card rates have fostered a competitive market. After an extensive study of consumer credit markets in California, the Retail Credit Advisory Committee concluded "Interest rates charged by California banks on consumer installment loans and credit card transactions . . . have been unregulated for at least fifty years, yet there was no evidence offered, and the Committee found none, of extortionate charges even in the face of accelerating increases in money and operational costs." [pp. 19-20] In our own surveys of credit card rates charged by banks and retailers in 1983 and 1984 in the two deregulated states of Arizona and Illinois, the rates reported were consistent with rates charged in other states that still had rate ceilings.

It is important to recognize that the disclosed rate is not the only element of competition. Focusing only on the APR overlooks the variety of services provided by credit cards, as well as the variety of pricing systems. For example, some bank cards provide credits towards the purchase of merchandise at a discount that are based on the amounts charged on the card. Some bank cards carry an annual fee; others do not. Available credit lines vary, as do credit standards. Thus, consumers may chose from a variety of credit card services and an array of different price systems. The stability of APRs on credit cards does not mean an absence of competition. Services provided with a card and other pricing aspects of the card may be the focus of competition, rather than the quoted APR.

Competition is also evidenced by what card issuers do and don't do. On the one hand, within the past few weeks we have seen the Manufacturers Hanover reduce its bank card rate to 17.8 percent from 19.8 percent. Also, Sears is marketing its Discover card without an annual fee for the first two years. And Citicorp is test marketing a preapproved Visa card that waives the usual $20 annual fee for the first year. On the other hand, we have not observed retailers levying an annual fee or abolishing the so-called "free period." Were the market noncompetitive, there would be no incentive for card issuers to cut their rates or eliminate their annual fees. Nor would there be a significant barrier to retailers' assessing an annual fee.

Significant Points

**1. Competition among credit cards is enhanced by frequent rate disclosure that has created a high level of awareness of credit card rates among cardholders.

**2. Rates on credit cards in markets without rate ceilings are consistent with rates in other states with rate ceilings.

**3. Competition in the market for credit cards appears to focus on innovative services and a variety of price systems rather than just on the quoted APR.

POTENTIAL EFFECTS OF CREDIT CARD RATE CEILINGS ON CONSUMERS

The effects of a rate ceiling on bank credit cards and retail credit cards will differ. Ulimately, the effects will fall upon consumers. The purpose of this section is to trace the impact of rate ceilings through the bank and retail card systems to determine which groups of consumers will be most affected and how.

Effects of Rate Ceilings on Bank Credit Cards.

Faced with a rate ceiling in a competitive market, bankers must find some means of offsetting the revenue losses of the scale envisioned by the bills before this committee. First, there are alternative sources of revenue. Banks can change their method of assessing finance charges, very likely by eliminating the "free period" and charging from the date of posting. Alternatively, banks might raise their annual fees. Consumers would probably react by further reducing the number of cards they hold. Such actions might very well lead to a greater concentration of bank cards in the hands of large banks--an anti-competitive result.

Finally, banks would quite likely raise merchant discounts; that is, the price they charge merchants to buy the bank card credit slips signed by consumers. Evidence supporting this price adjustment may be found in our study of merchant discounts in Arkansas at the time all credit was subject to the ten percent usury ceiling. Whereas the average discount rates paid by retailers on bank credit cards ranged from 2.0 percent in Illinois to 3.6 percent in Louisiana, the average merchant discount paid bankers by Arkansas retailers was 5.5 percent.

Increases in merchant discounts will affect both retailers and their customers. On the one hand, small merchants carrying low-priced items would be affected more adversely than large retailers with "big ticket" items. The lower the volume of business and the lower the average sales ticket, the higher will be the merchant discount rate. Consequently, small retailers selling low-priced goods may be forced to discontinue accepting bank cards in order to remain competitive on their cash prices. Such actions will, of course, adversely affect their customers. Larger merchants, who also operate in a competitive environment, will have to pack the higher costs of accepting credit cards into their cash prices. Many consumers who purchase for cash do not have bank cards because their incomes or other indices of risk do not justify their receiving a card. Thus, cash buyers will be forced to subsidize credit buyers--or, as a general rule, less affluent consumers will be subsidizing more affluent consumers.

Banks may also respond to lowered income from finance charges by lowering costs, especially the costs of bad debts. In other words, they will raise their credit standards. Which consumers are most affected by this effort to cut costs? To identify this group, we can turn to credit-scoring systems that are commonly used to evaluate credit applicants. Examination of the factors associated with low credit scores suggest that those consumers that would be denied credit are likely to be young, short-time on the job, renters, and with low or unreliable incomes. Once again we find that those consumes who have the least end up paying the most for government intervention in the credit markets.

Finally, those banks with small credit card portfolios would probably be forced to sell to competitors who could cope with the lowered finance income because of their economies of scale. The greater concentration in the bank credit card industry could not be counted upon to improve the welfare of consumers.

Rate Ceilings on Retail Credit Cards.

The most likely effect of a reduction of rate ceilings on retail credit cards would be to drive up their cash prices in order to offset the revenues lost from finance charges. Thus, cash buyers would be forced to subsidize credit buyers. As in the case of banks, retailers would also be likely to raise credit standards. In the study cited earlier, Shay and Dunkelberg found that, when a bank card credit scoring system was applied to retail credit card holders, a ten-point increase in the required credit score reduced the number of accepted applicants by 6.6 percent. However, 22 percent of those with incomes of less than $10,000 would have been rejected, contrasted to only three percent of those with incomes of $10,000 or more.

Significant Points

**1. National rate ceilings would force banks to increase their income by eliminating the "free period," raising annual fees or increasing merchant discounts. The last, and very likely tactic, will ultimately result in cash buyers subsidizing credit buyers.

**2. Lowered rate ceilings on retail credit cards would cause cash buyers to subsidize credit buyers.

**3. Rate ceilings on credit cards would generally lead card issuers to raise their credit standards, thus reducing access to credit by consumers who are young, short time on the job, with low or unstable incomes.

**4. Rate ceilings would tend to increase concentration in the bank credit card field and disadvantage small retailers selling low-priced items.

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Chairman **Annunzio**. Thank you very much, Mr. Johnson. It is good to have you back before the subcommittee.

Mr. Hunt, as representative of the American Bankers Association, I don't know whether you have any figures, but we have had, I feel, an excellent hearing this morning. All of the witnesses have made a contribution. But one subject that we didn't touch on is bankruptcy. These credit card people being charged 22 percent and so forth, are there any figures available of how many people are declaring bankruptcy because of these high interest rate charges on credit cards? They overspend just like we do in the Government.

Mr. **Hunt**. To the best of my knowledge, revolving credit is about 20 percent of consumer debt if you excluded mortgages.

Chairman **Annunzio**. In your own bank, do you hear of people declaring bankruptcy because they can't meet the payments on their credit cards?

Mr. **Hunt**. At the Bank of Virginia, we don't charge 22 percent, but we have bankruptcy. They run about 25 percent of our losses.

Chairman **Annunzio**. Of all loans, 25 percent——

Mr. **Hunt**. I am just talking about bank cards.

Chairman **Annunzio**. What is your rate in Virginia?

Mr. **Hunt**. Eighteen percent.

Chairman **Annunzio**. Well, that is—you painted a picture this morning of how difficult it is for banks to make a profit on credit card operations. What was the mood of the American Bankers Association at the bank credit conference they had 4 weeks ago? One newsletter reported that the credit card executives were jubilant about their business; they were especially gloating over profits.

Mr. **Hunt**. I didn't attend, unfortunately, but I think the business is better than it was in 1980. I was in the business then also.

Obviously times are better, rates are down and you become more efficient. You try to become more efficient.

When you talked about deregulation earlier and phone prices and that sort of thing, that is a big part of this business. Those things go up even more for a business like this than for the average consumer.

Chairman **Annunzio**. Do you feel deregulation has worked to the benefit of the consumers?

Mr. **Hunt**. I think the consumer can go to the bank today and put his money in the bank in a 2- or 3-year certificate and get paid higher than the prime rate the bank is charging on loans.

Chairman **Annunzio**. I wonder if Chase Manhattan used any of their money they made on credit cards to buy these associations in Maryland?

Mr. **Hunt**. I am not privy to that.

Mr. **Hiler**. Dr. Johnson, I don't know whether it is because of the fact you are a Hoosier or from West Lafayette, but I found I agreed with a tremendous amount of your testimony.

I wonder if you might tell the subcommittee a little more about the organization you are with, the Institute for Credit.

Mr. **Johnson**. When I was on the commission on consumer finance, and in the process of undertaking responsibilities assigned by the Congress, it became apparent there was an awful lot of missing information that people were having to establish without much knowledge of what was going on in the consumer credit, mortgage credit industry.

There has been relatively little research within the industry over many years, and so I felt that we should start a research center, which we did in 1974. We are the only one of its kind in the world.

We focus on issues of public policy such as rate ceilings. We did an extensive study on consumer bankruptcies.

We did a study for the Federal Trade Commission on the changes they were proposing in creditors' remedies. We did a study for the Federal Reserve attempting to estimate some of the costs of compliance, particularly regulation B under the Equal Credit Opportunity Act.

We are currently undertaking studies of variable rate auto loans, variable rate personal loans. We are proposing to the retailers a renewed cost study since the last one was done in 1975.

And that was restricted to the State of New York. And we think we have some better ideas on how to do it at the present time.

So we also do some studies that would help internal management such as credit scoring systems. We have done some studies on how consumers use credit, why they use particular kinds, how is a consumer different at all from those who go to banks versus those who go to finance committees. We look at consumer shopping behavior and the extent to which they shop for rates as opposed to monthly payment.

Mr. HILER. Are you aware of any organization that has studied this issue to the degree and depth that your organization has?

Mr. JOHNSON. No; we are the only one of our kind. Indeed, we have had visitors from Japan, England, Sweden and Canada come visit with us and stay with us some length of time in order to share their interest and their knowledge with us, and we have gone to Japan, given lectures to consortiums there on the use of consumer credit in the United States.

Mr. HILER. It was mentioned, and I believe you were here early on for the testimony by Congressman Biaggi, that—you know, when you throw everything aside and whether it is logical or not logical, the fact is that three States in the country have imposed fairly strict limitations. Arkansas was mentioned. And it is working there. And Washington and Alaska were the other two States.

I wondered if you might comment on any studies or any information or any analysis your organization has done of those three States or any one of those States in particular.

Mr. JOHNSON. Texas is also a State that has that kind of a floating ceiling and I think they were mentioned in the testimony, and it happens we were just in Texas about a month ago, and Texas bankers are happy with 14 to 15 percent, whatever that rate is that was quoted. They are not showing it.

Texas bankers holding around 80 percent of the entire bank card portfolio in Texas have left the State and moved their operations out of the State.

In the State of Washington, the banks there have adopted the more favored lender clause, which permits them to charge much higher rates because they can charge the rate charged by the highest rate lender in the State.

So they are not really operating under the law and therefore they don't feel the pain.

Mr. HILER. How about Arkansas?

Mr. JOHNSON. I am not familiar with Arkansas, and whether the banks are moving out of the State there or not or the extent to which they are also—well, they wouldn't find the most favored lender clause useful there because everybody is under the same rate. I am not familiar enough with Arkansas to comment.

Mr. HILER. What is the—my time has expired, but I appreciate your testimony.

Thank you.

Chairman ANNUNZIO. Mr. Schumer is recognized for 5 minutes.

Mr. SCHUMER. I thank the chairman and the Members of this subcommittee for allowing me to ask questions even though I am not on the subcommittee.

Just one more question, Mr. Johnson, about your organization. Are you funded by any consumer organization or only by credit card issuers?

Mr. JOHNSON. We are funded by a complete cross section of the industry. We don't have funds from consumer groups. They, as you well know, are underfunded themselves, and we would not ask them for funds.

Mr. SCHUMER. So you have an industry orientation?

Mr. JOHNSON. We have representatives of consumer groups on the advisory council, including one of the past heads of the Consumer Law Center in Boston.

Mr. SCHUMER. My next question is to Mr. Hunt, and then I will ask a few of my friends, Mr. Leichter.

You said before, Mr. Hunt, that the business has gotten more profitable and you have become more efficient. Is that true?

Mr. HUNT. Yes.

Mr. SCHUMER. Have consumers benefited from that increased profitability in any way?

Mr. HUNT. I think they clearly have. I think they get more utility with a card than they did before.

Mr. SCHUMER. I don't understand what utility with the card means.

Mr. HUNT. What you can do with it, where you can go to use it, the other benefits you can attach to the card, card registration, discount services.

Mr. SCHUMER. Do you have any indication that consumers would prefer more utility to lower interest rates or lower fees? Why is it that extra profitability has gone into increased utility as opposed to lower prices?

Mr. HUNT. Because—from the banking perspective, we try to differentiate our products and segment our market like all marketing people do.

Mr. SCHUMER. Let me ask a question. I have a list here, these are the 50 largest issuers of credit cards in the United States, 50 largest issuers: Citibank, J.C. Penney, Shell Oil, Bank of America, Union Oil. Not one except Manufacturer Hanover has a rate below 18 percent. Not a single one.

Do you find that a little troubling?

Mr. HUNT. Do I personally? Not really.

Mr. SCHUMER. Why is that?

Mr. HUNT. Because I think the value of the card is represented by the price people are willing to pay for it.

Mr. SCHUMER. Where would I go as a New Yorker, if I just wanted to use a card in a limited way, I really didn't care if somebody with lower income than me wouldn't have a card available, and I would rather have 16 percent interest rate.

Mr. HUNT. Bank of New York now.

Mr. SCHUMER. The Bank of New York—what is their rate?

Mr. HUNT. 16.8, I think.

Mr. SCHUMER. Why is the Bank of New York able to do it with all the costs and other things you mentioned and not any of the major issuers?

Mr. HUNT. I am not sure. I don't know what their strategy is.

Mr. SCHUMER. Why has your bank not pursued a strategy of lowering interest rates as opposed to increasing the utility of the card?

Mr. HUNT. Well, when we try to acquire customers, we try all different types of packages to see what the customer is most sensitive to. Whether they are sensitive to the rate, whether they want the benefits.

When we do solicitations we test pockets all over the place, from higher fees, lower fees. We have three different credit card rates that we charge for different products. It depends on the segment of the market and what your plan is.

Mr. SCHUMER. Have you ever offered, say, in this area, credit cards at a lower rate?

Mr. HUNT. We have a credit card tied to a second deed of trust at prime plus two we offer in this market.

Mr. SCHUMER. I thought you said your rate was 18 percent before. Is this secured credit, a mortgage, or something like that?

Mr. HUNT. This is the second deed of trust.

Mr. SCHUMER. Are you making money on this card? Do you have any losses on it at all?

Mr. HUNT. Well, it is a new product so it is hard to tell. We have had one—when you look at the market plans we can invoke at Bank of Virginia, don't get us confused with the guys on the chart.

Mr. SCHUMER. I understand that. I am sure you hope and we all hope that one day you will be on that chart. Maybe by lowering your rates a little bit.

As I understand it, on these types of credit cards which offer a much lower rate of return, with some kind of security, there have been no losses. Is that fair?

Mr. HUNT. Could I make one clarification?

If the average size credit card balance is $500, the average size balance on a second deed of trust is going to be $20,000—and the cost is almost the same to provide the service, but if you convert that to basis points some percentages, which is what we have to do, the cost of delivery is very slight——

Mr. SCHUMER. My point is simply there is plenty of profit in issue with a lower rate.

My time has expired. I am sorry. I could not question my colleague, Senator Leichter. We served in the State legislature together.

I thank Senator Leichter, who has been a people's voice in Albany for longer than almost anybody else. We appreciate your coming down.

Mr. WYLIE. Thank you very much, Mr. Chairman.

I congratulate you on having an excellent panel here this morning which has painted a broad spectrum of opinion on a difficult issue. I am glad to have signed a letter with Congressman Hiler to get Dr. Johnson here and thank you for accommodating us in that regard.

We have talked basically this morning, and I made this point with Ms. Seger a little earlier, about bank credit card operations, but there are also retail credit card operations of course. How is the situation different as far as retail credit card operations are concerned? And I see at the top of the list is Sears, of course, which is the best known of the retail credit card operations. How is that different from the bank card operations.

Mr. JOHNSON. Primarily, the customer and many retail credit managers will be unhappy at this credit but I think, basically, the customer has a Sears card because the customer likes Sears merchandise and Sears' service. You want the merchandise and service before you get the card and the card merely facilitates the convenience of getting the merchandise at the time you are on the floor.

In the case of a bank card, you simply want access to a broad variety of merchants, and it becomes very difficult for the bank card to make you beholden to the Bank of Virginia or any other bank because the Visa cards all look the same and MasterCards all kind of look the same, so I think customer loyalty to the supplier of the card is much greater in the case of a retail card than in the case of a bank card.

And this is one of the reasons, as Mr. Hunt said, that the banks are trying to segment their market to build customer loyalty to their card and engaging in lots of nonprice competition, adding bells and whistles and discounts and other things to the card, not so much competing on the annual percentage rate but competing on the kinds of services you can tie to the card.

I think that is a very basic difference. A secondary difference is in the cost of the procedures. A bank has other ways in which to duck the limitations on the prices that it can charge by increasing the merchant discount, increasing the annual fee, or changing its billing system. I think there are some fundamental differences between the two cards.

Mr. WYLIE. These three bills all apply to credit cards across the board, be they retail credit cards, gasoline credit cards or bank credit cards. Without indicating which direction I might be going, if any, should there be a distinction?

Mr. JOHNSON. Yes, I think—well, I take that back. I don't think there should be any distinction because I think they all ought to be treated alike without a rate ceiling.

Mr. WYLIE. Mr. Hunt, Dr. Johnson was asked about the model that we have been told about in Arkansas. We went through this issue of interest rates in Arkansas where they had a State usury ceiling vis-a-vis their constitution, and they came to us and asked us to have a national usury ceiling override because of some problems that they had encountered.

What has been your experience, or have you had any? Do you have any knowledge of how banks in Arkansas have fared with a ceiling on credit card charges of 12½ to 13 percent?

Mr. **Hunt**. No, I don't. I can venture a guess if you would like to hear it.

Mr. **Wylie**. Venture a guess.

Mr. **Hunt**. My guess is, they are very selective about whom they give the card because you don't have a margin for losses. I would also guess if you would look in the credit bureau on file, there would be more cards issued in Arkansas from banks outside the State of Arkansas.

Mr. **Wylie**. Why shouldn't Mr. Schumer, who is a good credit card risk, have a lower rate than someone who isn't?

Mr. **Hunt**. He has the option of paying no finance charge. He can pay it with the 25-day grace period.

Mr. **Wylie**. The gentleman from New York mentioned the example of how we can bring these charges down. There is an advertisement in the paper today that says 16.98 percent, then down at the bottom in very small language—and I read fairly well without my glasses, but this time I need my contacts plus my bifocals to read this fine print—it says:

> The variable annual percentage rate applied to your account will be 16.98 percent or 800 basis points over the average interest rate for the previous quarter on 90-day certificates of deposits sold in the secondary market, whichever is higher.

What does that mean?

Mr. **Hunt**. I don't know.

Mr. **Wylie**. I don't know either.

Mr. **Hunt**. What they have done is identified a funding index and put a spread over it.

Mr. **Wylie**. It sounds like it is disjunctive and if they want to charge you 800-percentage basis points, they can.

Mr. **Hunt**. There are many variable credit rates in the country today.

Mr. **Wylie**. My time has expired. Thank you very much.

Chairman **Annunzio**. This subcommittee will recall, we sent some people down to Arkansas, and I am going to have our staff report some of their findings to you. It was 3 or 5 years ago we had a study made in the State of Arkansas.

Mr. **Ridge**. Thank you.

Dr. Johnson, I have a couple of questions for you. Are you familiar with the specific contents of the bill proposed by my colleague from New York, Mr. Schumer, the 6-percent cap above 3-month Treasury bills?

Mr. **Johnson**. Yes; I read the bill.

Mr. **Ridge**. Do you recall approximately what the Treasury bill rates might have been in 1979 or 1980? Can you look back and tell me if his bill had been applied back in 1979, 1980, and 1981—if it were strictly applied—what the consumer would have been paying for credit cards?

Mr. **Johnson**. I am afraid I can't unless that chart over there—it starts in 1981. No, I am afraid I can't, Mr. Ridge.

Mr. Ridge. If you would, some time at your convenience, make that available to me, just applying this formula to the rates available in 1979 and 1980.

Mr. Johnson. I will do that for both bills.

Mr. Ridge. Senator, and Mr. Fox, I appreciate very much your concern about disclosure and about the extension, sometimes the unsolicited extension, of credit through the mail to low-income, marginally creditworthy consumers, and the difficulties and oftentimes hardship they impose, they get in, get the credit and it just builds up, and I believe that is a problem we have to address, although I do not think mandating a reduction in interest rates is the way you may go about addressing that particular problem.

I do not think it affects all that many of the 90 million credit cardholders out there but I do recognize it as a problem. I have seen it in my private law practice, I have seen it among other members of the community.

Someone who is not creditworthy who is certainly on the margin and gets the unsolicited extension of $2,000 in credit and gets himself or herself in deeper and deeper. I do not think mandating lower rates helps that particular consumer, and I might look to you, if you would offer some suggestions what might be done to either avoid that problem or help that consumer.

Mr. Fox. I have examined the solicitations for credit cards that I received and that members of our staff have received. Some of them are applications, some of them are the preapproved credit versions. There is little difference between them, and there is also very little information on them beyond what is in the flashy pages with multiple color. We found we could generally find an interest rate, sometimes could find an annual fee, but never could find any information on grace periods, on late fees, any of the other aspects of credit card costs.

The system seems to be that you are supposed to apply for the card, get the card, and then you receive the full Truth in Lending Act disclosures. That might have worked well in the days when people walked into their banks and submitted an application and got the paperwork at that time.

I would suggest at a minimum we might want to examine moving some of those disclosures to the point at which the solicitation is received instead of the point at which the card is received. That might serve some of the low-income people, some of the less creditworthy people who get into trouble. It is also going to serve more affluent consumers who want to shop around and understand what their best option is and are frustrated by the lack of information.

As a further point on that, I received one of these applications from a bank in Maryland, found a phone number for the credit card operation and called to get some of this information, and got contradictory answers from different people. The person I was first referred to told me something that sounded wrong to me, might not have sounded wrong to another consumer and it was only after I talked to this person's supervisor I got the full information.

I would not have been able to compare this card against another card on the basis of the mailing, on the basis of the phone call, which required me to look for a phone number; there is none in the mailing. I had to call information to get the phone number.

Only after I talked to the second person could I compare that cost against another card. It would be a great service to consumers to have all of the information that has to do with the cost of a credit card up front, at the time of the mailing. These mailings have five or six or seven pieces in them already. There is not an extra cost to toning down one of the four-color slick pieces and putting some disclosure on. And it would benefit consumers greatly.

Mr. **Ridge**. Senator, would you care to comment? I notice that is an area of concern to you.

Mr. **Leicther**. Thank you. I agree with Mr. Fox's comments. You know, unless you want to in some way legislatively or by regulation try to control how the cards are going to be marketed, which I don't think we want to do.

I am not sure that we can avoid the problem that you focused on, and I think it is a problem. Except by having some limitation on the interest rates, which is then going to, I think, impose probably more prudent management on the banks. I think presently they can send them out as widely as they want to and I think there is a sufficient margin of profit, great profit as I tried to point out, so there is no reason for them to try to circulate the card as widely as they can.

I think if there were these limitations and they had to be more careful as to their loss, then I think that you would find out that the cards wouldn't be marketed as widely as they are now which unfortunately I think catches people who shouldn't be given these cards and who only get in trouble because they have them.

Mr. **Ridge**. Would the chairman extend me another minute or two?

Chairman **Annunzio**. Certainly.

Mr. **Wylie**. For the record, the T-bill rate was 16.925 percent. I think that probably was the highest it reached.

Mr. **Schumer**. If the gentleman would yield, if the T-bill reached that rate again the ceiling would be six points above that rate. However, banks could charge lower as they did in 1981.

Chairman **Annunzio**. Senator, in the event that the subcommittee should pass legislation with a cap, what is your opinion? Can these banks adapt to the cap or would they go out of business?

Mr. **Leicther**. Would the banks—I didn't quite understand you.

Chairman **Annunzio**. Let's assume that this subcommittee passes legislation with a cap on interest rates for credit cards. How would this affect the banks? Would they adapt to it or would they go out of business?

Mr. **Leicther**. I don't think we are going to find any of them going out of business. I think it is clear now, Mr. Chairman, I just don't think there is any question about it, and I am sure Mr. Hunt would agree that at the present time credit cards are extremely profitable. There is no doubt about it. I understand some of the points Mr. Johnson made and concern if we had some sort of cap you would just find the fees to the merchants would go up. I question that because it seems to me that right now there is such a wide spread between the cost of money between the expense of administering these cards, between the loss ratio and what the banks are receiving, that if you limited that to some extent, and I think maybe you would come up with a bill that would be somewhat more generous than Congressman Biaggi's or more generous than Congressman Schumer's, although I think these would be sufficient leeway for the banks if you added 6 percent to the 90-day Treasury bills. But I can't conceive that this is going to present any serious problems to the banks, and I am sure the committee wouldn't do anything that would in fact impair the viability of the banks.

Chairman ANNUNZIO. Mr. Hunt, what does your bank charge on passbook accounts? What interest do you pay?

Mr. HUNT. We have statements savings accounts at 5½, we pay money market rates for the new savings products, which are currently about 7 to 7½ percent. I don't know what they are this week, they change weekly. We pay competitive rates at the yield curve following the Treasury's. We also still have, I should point out, an awful lot of certificates in the bank at 14 percent that have not yet matured. Long-term money we have booked over the last 3 years when rates were higher. So when we look at the funding a credit card portfolio, we fund it on the margin because it is not a short-term asset.

Chairman ANNUNZIO. In your passbook savings you pay out, what is that number?

Mr. HUNT. Five and a half.

Chairman ANNUNZIO. Now, you have your credit cards and—what do you charge on those, 18 percent?

Mr. HUNT. Eighteen percent. We have different card products.

Mr. HILER. Would the gentleman yield?

What is your average cost of funds?

Mr. HUNT. For the entire bank?

Mr. HILER. For the entire bank.

Mr. HUNT. I would have to guess it would be in the 8-percent range.

Mr. HILER. A small percentage of your liabilities are in passbook savings?

Mr. HUNT. Oh, yes, and it has been drifting down obviously over the last several years, and that rate goes to market rate when the law changes——

Mr. HILER. One of the benefits of deregulation is that people get something for their money rather than a passbook savings rate.

Mr. HUNT. They certainly do. And those people have options today, and we tell them about it. Some people just like the product.

Chairman ANNUNZIO. You are getting about 120 percent more on your money for credit cards, above the cost of the money you are paying. You said the average cost of money in your institution, at your bank, was 12 percent.

Mr. HILER. Eight percent.

Chairman ANNUNZIO. Eight percent. That is the average cost. If you are collecting 16 percent you are making 120 percent on credit cards. That is good business.

Mr. HUNT. Could I clarify that?

Chairman ANNUNZIO. Yes, sure.

Mr. HUNT. I think that is a good analogy to try to make, but what happens is you have a lot of money in the bank—banks don't allocate funds on an average basis to my knowledge. You have commercial loans at prime, you have consumer loans, you use consumer loans for and you have your longer-term assets. It is more important for the bank to try to match up maturity, asset maturity with liability maturity to insure a spread.

Chairman **Annunzio**. I am going to ask Mr. Prins to give us a report on that Arkansas study. I ordered that study about 3 years ago. It was mentioned today and I would like it to be part of the record.

Mr. **Prins**. Thank you, Mr. Chairman.

The only reason I wanted to bring this up is I believe there is a misrepresentation that the people of the State of Arkansas are sitting down there scheming for higher interest rates because they are being overcharged on their retail goods. As Dr. Johnson said, their merchant discount was higher and therefore the cost of retail goods was higher in Arkansas. I believe that the study that you did came to that conclusion; is that correct, Dr. Johnson?

Mr. **Johnson**. That is correct, Mr. Prins, and that was at the time you had the 10-percent usury statute. Recall on November 2, 1982, the citizens of Arkansas voted for a higher rate, the first time I think almost in history——

Mr. **Prins**. After they defeated the referendum six times running. Unfortunately, in a democracy it is not by the number of times, so they lose on a 6-to-1 ratio but that one time they lose. What I wanted to point out was that Mr. Annunzio did the totally unconscionable thing in this, he sent people to Arkansas to check these facts out, and we took a list of automobiles, we took a list of 100 different items, and our investigators went into Arkansas and compared those prices in Arkansas as opposed to prices in the neighboring States. On the 100 items, we did not find one item that was higher in the State of Arkansas. We did not find one automobile price that was higher in the State of Arkansas. In fact, we found just the reverse, that the Arkansas merchants, the Arkansas car dealers, went into the neighboring States and spent money in the newspaper telling the people in Texas and in Tennessee, don't buy an automobile in Texas, don't buy an automobile in Tennessee, come to Arkansas, as we can save you money. They openly published this.

Unfortunately, Mr. Annunzio was strongly criticized for sending people down there to check on these facts. In fact, one member of the committee asked for the notes of the investigators, called us spies, and all we did was go down and look at the newspapers and talk to the merchants down there. We didn't find one merchant who told my people that they had to charge extra prices.

Now, there is one thing we didn't tell these folks that I think perhaps you did. We didn't tell them we were congressional investigators, we told them we were shoppers. Now, you went down and told the folks that you were doing a study on the cost of credit in Arkansas; isn't that correct?

Mr. **Johnson**. We didn't—let me straighten it out. The study on the pricing was done by Prof. Gene Lynch at the University of Arkansas some years ago. We did not at CRC do a pricing study in Arkansas. What we did was to gather from the banks and from the retailers information on what the merchant discount was and we just said we are here to study consumer credit in Arkansas.

Mr. **Prins**. Let me ask you this one final question, and I know the time is short and I apologize for taking this time.

Do you have any hard fast knowledge that you can present before this subcommittee today to show that prices in Arkansas for retail goods, for automobiles, or for credit, are higher than they are in the neighboring States?

Mr. **Johnson**. Not at the present time, no, sir.

Mr. **Prins**. Thank you.

Mr. **Wylie**. Mr. Chairman, on this chart over here we have top credit card lenders and their rates, and it shows the rate on the left, the interest rate. What is the figure on the left there?

Chairman **Annunzio**. Area interest rates——

Mr. **Wylie**. What I would like to have added to that chart, if we may, is the cost of the card up front, the charge for the card, the annual fee, and also the merchant discount rate.

Chairman **Annunzio**. On behalf of the subcommittee, I want to thank the panel for the time and the testimony you have given us this morning.

The subcommittee will now stand adjourned, and we want to assure the panel when time permits we will start a markup session on the legislation in the subcommittee.

[Whereupon, at 1:20 p.m., the subcommittee adjourned subject to the call of the Chair.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR INCLUSION IN THE RECORD

BANKCARD HOLDERS OF AMERICA
333 PENNSYLVANIA AVE., S.E., WASHINGTON, D.C. 20003, 202/543-5805
A non-profit consumer association dedicated to protecting the interests of bank card holders.

TESTIMONY OF MARLA R. KAPLAN
ASSOCIATE DIRECTOR
BANKCARD HOLDERS OF AMERICA
BEFORE THE HOUSE SUBCOMMITTEE ON
CONSUMER AFFAIRS AND COINAGE
OCTOBER 29, 1985

Mr. Chairman:

We are pleased to submit testimony to the Subcommittee on behalf of the approximately 100,000 members of Bankcard Holders of America (BHA).

My name is Marla Kaplan and I am the Associate Director of BHA. We are a national, non-profit consumer organization dedicated to educating consumers on their rights and responsibilities as credit card users. BHA is the only consumer group working exclusively on credit card issues. Founded in 1980, BHA is completely independent, supported solely by membership dues and receives no corporate, government or foundation support. We are not a lobbying organization and have no connection with any bank, credit card company or financial institution. Our membership consists of individual consumers from every state.

We are submitting our comments because BHA believes that consumers are paying far too much interest on their credit card balances. Furthermore, we have come to the somewhat unfortunate conclusion that federal legislation is necessary because banks have been unwilling to adjust consumer rates to the real cost of money in the economy. As a consumer education organization, we have always focused on what action the consumer can and should take in order to get the most out of the credit card marketplace; we believe that the most effective way to make the credit card industry sensitive to consumers' needs is to create a consumer constituency that is informed enough to shop for the best credit card account. What we have found on this issue is a credit card industry unwilling to lower interest rates. Banks persist in the mistaken belief that consumers are not sensitive to changes in credit card interest rates. The truth, however, is that because of inadequate information and a lack of real competition, consumers just don't know where to turn.

We are pleased to see that both Rep. Biaggi and Rep. Schumer have proposed solutions to this problem. Both bills have merit and my comments today will address the need to resort to a legislative remedy to protect consumers from unreasonably high interest rates on credit cards. I will conclude with some specifics on what we believe should be included in consumer protection legislation for credit card users.

After polling our 100,000 members and looking at industry trends, we are convinced that there are five strong reasons why consumers need protection in this area.

FIRST, CONSUMERS WANT CREDIT CARDS WHICH OFFER LOWER INTEREST RATES AND THEY ARE WILLING TO SWITCH IN ORDER TO GET THEM

BHA recently polled our 100,000 members in our "1985 Credit Card Users Survey". Three-thousand-five-hundred (3,500) members responded with specific information about their concerns as credit card users. We asked them "What do you feel is the most important issue facing credit card consumers?". High interest rates were rated number 1 on their list. We also asked if they would switch to another Visa or Mastercard if it offered a lower rate, and 66% -- two out of three -- said yes. 79% of these card-users reported paying 18% or more on their credit card balances and 69% said they carry over some balance on their card--with 38% maintaining a monthly balance of over $500.

The banks have stubbornly insisted on maintaining inflated profits in their credit card operations and suggest that consumers will not choose to subscribe to cards which will save them money. Our members tell us differently.

SECOND, EVEN THE MOST INFORMED CONSUMERS FIND THEMSELVES WITH FEW CHOICES IN THE CREDIT CARD MARKETPLACE.

Much of our educational effort is designed to inform consumers about what a credit card actually is. A credit card is a personal loan that you access with a piece of plastic. As with any loan, it is important to shop around to make sure you are getting the best rate on the money you are borrowing. Few of us accept the first car loan or mortgage offer we can find. Wise consumers research loan rates first and then apply for the loan that best fits our needs. The same should be true with credit cards. Consumers need to shop in order to get the best rates.

However, as we communicate this message to consumers with pamphlets on such topics as "How To Shop For A Bank Card" and our "No Annual Fee List", we receive responses like the following:

"...I know I am supposed to look around for the best interest rate, but where do those deals exist? I certainly can't find them in my area..." or "...I am receiving all sorts of offers on credit cards but I can't seem to figure out how to get an offer for a card with decent rates...do you know where I can find one?"

Unfortunately, we too have had a difficult time providing our members with names of banks that offer reasonable interest rates.

Credit limits average between $500 and $2000 per card, (a relatively small loan amount by bank standards) but because of the economies of scale involved, credit card "loans" are much cheaper to administer than individual small consumer loans. However, the way credit card interest rates are determined today, a consumer could probably get a cheaper rate from their local loan shark.

Credit cards are no longer a luxury for the rich. They are a necessity for the millions of consumers who have grown to depend on them as an alternative payment mechanism. Seventy percent of all consumers have at least one credit card. The average interest rate on a credit card is 18.62% (according to the Federal Reserve Board -- August 1985). We challenge the credit card industry to start providing credit cards that reflect more equitable interest rates for consumers and more reasonable profit margins for banks.

THIRD, BANKS HAVE SHOWN US THAT THEY WILL NOT BE RESPONSIVE TO CHANGES IN THE ECONOMY ON A VOLUNTARY BASIS.

In the last four years, the three main economic indices have all fallen by 50%, yet interest rates on credit cards have remained the same. This information was just included in a study released by the Consumer Federation of America. In response to the drop in rates, interest rates on auto loans, mortgages and commercial loans have all declined. Why haven't credit card loans followed suit? Because they haven't had to. Instead, the banks compete by offering more so-called "benefits" such as book-of-the-month clubs, travel insurance, rebates, credit card protection, etc.

In addition, interest rates are just one way in which banks make money on credit cards. There are annual fees (which vary between $15 and $25 for a standard card), there is the merchant discount fee (which ranges between 1% and 5% on each purchase made), and in many cases there are transaction fees, service fees, late fees and even immediate accrual of interest from the date of posting.

A FOURTH POINT IS THAT BANKS ARE CURRENTLY MAKING PROFITS AT INTEREST RATES FAR LOWER THAN THE NATIONAL AVERAGE OF 18.4%

Arkansas, whose state statute serves as a model for Rep. Biaggi's bill, is a case in point. We are aware of banks there, such as Union National Bank of Little Rock, that now charge 12.5% on their credit cards and admit to making a fair profit.

Washington State has interest rates averaging 15%. Ranier National Bank in Seattle charges 15%. Locally, Chevy Chase Savings and Loan in Maryland now offers a card at 14%, with no annual fee.

These rates all come from relatively small banks that do not benefit from the savings associated with the economies of scale enjoyed by the larger card issuers. Experts in the field agree that the more cards an issuer processes, the lower the unit cost of processing each card. If Chevy Chase S&L or Union National Bank of Little Rock or Ranier National Bank in Seattle can charge below average rates, why don't the larger money center banks even come close? We think the answer is because the large money center banks can afford to move to states like South Dakota and Delaware with more lenient (that is, more favorable to the banks) interest rate laws, and know they they can find a way to market their cards at the higher rates.

FIFTH, CONSUMERS WILL ONLY BE PROTECTED FROM UNREASONABLY HIGH INTEREST RATES ON CREDIT CARDS IF LEGISLATION IS PASSED ON A FEDERAL LEVEL

BHA does not always favor federal legislation as the best way to protect consumers. We believe that the states should have some flexibility in determining their own banking laws, and that state legislatures are often able to come up with regulations that are more consumer-oriented. However, the fact is that interstate banking already exists in the credit card industry. Consumers receive credit card soliciations from all over the country, and often they have no way of knowing which state laws regulate these cards.

If a bank is large enough, it can locate its credit card operations anywhere in the country. This means that those banks which benefit most from the economies of scale are also freer to charge any rate permitted by the state in which they relocate. Individual states are hampered in passing legislation to limit interest rates because by doing so, they risk losing their largest credit card issuers to more lenient states. New York, Maryland and Washington, D.C. are good examples of this phenomenon. Texas has also experienced the 'bank exodus' as a result of their rejection of legislation to allow annual fees on credit cards.

To refer this problem back to the states is simply to abdicate responsibility for a problem that can only be effectively solved on the federal level.

I would now like to answer some of the claims made by the banking industry in defense of high interest rates on credit card balances:

CLAIM: Roughly 30% of consumers take advantage of the "free ride" by paying off their credit card bills in full each month. Therefore, consumers who maintain balances must pay higher interest rates in order to subsidize those who do not carry over charges.

RESPONSE: The banks used this argument very effectively in the late 70's and early 80's. They lobbied state legislatures to allow annual fees for credit cards to pay for the administrative costs associated with the card. We'd like to ask what the annual fee is now being used for, if not to pay for those administrative costs.

CLAIM: Credit card operations have only recently begun to make a profit due to heavy losses incurred during the late 70's and early 80's, when the cost of money began to exceed interest rate ceilings.

RESPONSE: While banks continue to refuse to provide information about their profit margins (both in the late 70's and now), it seems highly unlikely that they would engage in the huge, expensive direct mail offerings of credit cards that we are now seeing if these new accounts did not provide a significant profit margin. In addition, the banks also receive money from the merchant discount fee, annual fees, transaction fees, service fees, late fees and increasingly, interest charged from the date of purchase.

The cost to banks to borrow money has been declining for over 8 years. During the last 18 months the cost of funds has remained low while credit card interest rates have remained stubbornly high. We believe this inaction can be attributed more to the banks' desire to make increased profits rather than to efforts to make up for previous losses.

CLAIM: Higher risk consumers will be pushed out of the credit card market if interest rates are lowered.

RESPONSE: We appreciate the banks' concern but in reality the situation that now exists is that many consumers have been given far too much credit. Credit overextension has become a very real problem in our economy. The Foundation for Consumer Credit (a non-profit organization that counsels consumers with credit problems) reports an increase in the requests for counseling on problems related to credit card overextension. At the same time, they report that banks are less inclined to refer delinquent customers to them and more inclined to refer problem cases directly to debt collectors. The solution to freezing out higher risk consumers is not to charge higher interest rates to all cardholders; rather, such higher risk prospective cardholders can be offered collateralized accounts or accounts with low credit limits.

CLAIM: Some states require banks to wait six months before they can raise rates. If the cost of money were suddenly to rise again, the banks might find themselves stuck in much the same situation they were in several years ago.

RESPONSE: Once again, all economic indices have declined steadily for four years. The banking industry has simply not acted. Furthermore, legislation to keep interest rates at a reasonable level can easily be written to pre-empt these state requirements. (Since both of the proposed bills tie the rates to a variable indicator that is designed to reflect the market, banks would be able to raise their rates if the need were to arise.)

CLAIM: Credit card fraud is on the rise; therefore, higher interest rates are necessary to cover the extra costs.

RESPONSE: It is important to note here that the bulk of the losses from credit card fraud come as a result of activity involving organized crime. The two largest sources of fraud include: (1) the so called "white plastic" scheme in which real credit card numbers are embossed onto phony white plastic cards and then pushed through the system with the help of willing merchants, and (2) the scam involving phony telephone marketers who call with an offer and then use the card number for other purposes. Both types of fraud require large scale operations that have nothing to do with the average consumer. Banks and their regulators must devise ways to address fraud where it exists at meaningful levels--penalize organized crime, not ordinary consumers. We do not consider it an appropriate solution to simply pass those costs on directly to the consumer who is generally not responsible for such abuses.

By now I hope you can see why we feel legislation in this case is the most appropriate remedy for this problem. In reviewing both the Biaggi and Schumer bills, we feel confident that an equitable solution to the problem of credit card interest rates can be reached.

I would like to add that, as an organization representing credit card holders, we recognize the importance of ensuring that the credit card industry remains profitable; it is in all our interests to make credit available to the people who need it. Nor do we want to inhibit banks from competing. Our main concern is that consumers' legitimate needs are calculated into any profit equation.

As a consumer education organization, we see our role here today as that of a voice for consumers, and as such, we are here to tell you that consumers know they are paying too much in credit card interest rates. Others have ably conducted the financial analyses to determine legitimate bank profit margins and justifiable consumer needs. Both Rep. Schumer and Rep. Biaggi offer solutions far better than the status quo. Whether you opt for the discount rate or T-Bills, whether you use the 5% or 6% ceiling, we are satisfied that both proposals are far more appropriate than the current system that allows banks to charge interest rates far out of line with the cost associated with other types of loans. Naturally, our preference is that the ceiling provide as low a rate as possible for consumers.

We urge that you address several concerns in any proposed legislation to protect consumers from unreasonably high credit card interest rates. They are as follows:

1) With regard to a study by the Federal Reserve Board to analyze the past profit margins for credit card operations, we think that such a study might by very helpful for future debates on credit card interest rates. However, we think the evidence is already strong enough to merit taking action now to ease the consumers' burden. We do not support a study designed to determine whether or not a ceiling is necessary. It is obvious to us that it is necessary; consumers have waited long enough.

2) We would like to see improved disclosure laws in order to ensure the added competition that we feel should come as a result of this legislation. One possible danger we see in requiring banks to lower their rates is that they may seek to make up for the change by imposing "hidden fees". For instance, will the bank begin to charge interest at the date of posting instead of allowing the more customary grace period of 25 to 30 after the bill is sent? Will the banks change their method of calculating interest so that interest is charged on the largest balance of the period instead of some other figure? Will service or late fees be imposed? In reviewing several credit card applications, we have found that it is often very difficult to find the interest rate. (In fact, there were instances when we could not find the rate on the promotional material.) It was even more difficult to find out when interest began to accrue. We would like to see some requirement that banks must make information available on promotional material, including the annual fee, the interest rate, the method of calculation and the date upon which interest will begin to accrue.

3) Finally, we believe that this federal ceiling should pre-empt any state law unless the state law provides better protection for the consumer.

In conclusion, I would like to thank Chairman Annunzio, Rep. Schumer, Rep. Biaggi and this committee for recognizing the importance of ensuring an equitable credit card marketplace for the millions of consumers who have come to depend on credit cards as an alternative payment mechanism.

Statement of Visa U.S.A.
Submitted to the
Subcommittee on Consumer Affairs & Coinage
Committee On Banking, Finance and Urban Affairs
United States House of Representatives
On
H.R. 1197 and H.R. 3408
Legislation To Limit Credit Card Interest Rates
October 1985

Visa U.S.A. Inc. ("Visa") is pleased to submit the following statement on proposed legislation for federal limits on credit card interest rates.

Visa is a for-profit membership organization, incorporated under the laws of the State of Delaware, which administers the Visa card program within the United States. The membership of the corporation is comprised of more than 16,000 commercial banks, savings and loan associations, and credit unions which participate in the program by issuing cards bearing the Visa name and logo to customers, and signing up merchants to accept the cards. As of June 30, 1985, the Visa card was held by approximately 88 million individuals and accepted at more than 2 million merchant outlets and member offices throughout the country. For the four quarters ending June 30, 1985, the total dollar volume of the Visa system in the U.S. exceeded $68 billion. Accordingly, Visa has a significant interest in legislation proposing to establish limits on the rates of interest charged on credit card accounts.

Proponents of such legislation assert that such limitations are necessary since finance charges on credit card accounts are, on the average, somewhat higher than rates applicable to other forms of consumer installment credit and commercial loans and are higher than open market interest rates such as the prime rate and Treasury bill rates. They further argue that, despite the numerous financial institutions issuing bank credit cards and the wide availability of credit cards issued by private card companies and retailers, there is no adequately functioning market for the establishment of credit card interest rates.

We believe there exists no justification for such limitations and we believe the basic assumptions upon which these proposals are premised are incorrect.

First, the proponents of controls point out that interest rates on federal funds and the prime rate have fallen over the past five years while interest rates on credit card loans have not. Hence, they conclude that there is no adequately functioning market mechanism for the establishment of interest rates on credit cards.

That credit card interest rates have not declined over the last four years in concert with open market rates is, in and of itself, an absolutely true statement. However, we respectfully submit that as an analysis of the efficiency of the market, that statement alone is seriously deficient because it omits a number of significant facts.

The federal funds rate, prime rate, Treasury bill rates and negotiable certificate of deposit (above $100,000) rates all have one thing in common. They are not now and never have been subject to state usury laws, federal price control laws or any other form of price regulation.

That is not today, and never has been true of credit card interest rates. For most of this century, consumer loan rates, including the maximum rates that can be charged on credit card balances, have been closely regulated by most states. The impact of that regulation was especially severe on the credit card industry during 1980 and 1981, the base years which proponents of controls use to generate statistics to prove their case.

In 1980 and 1981, most states had in effect usury laws so restrictive that they forced banks who wished to continue offering their customers credit cards, to lend money out at a rate that was often lower than the banks' cost of funds or so close to the cost of funds that the spread was insufficient to cover the heavy administrative costs associated with credit card programs. The result was that the industry lost hundreds of millions of dollars a year on credit card portfolios. In 1980 our members lost an estimated $188 million on their Visa portfolios alone. In 1981 losses approximated $132 million. Comparable losses were incurred on MasterCard portfolios. The magnitude of these losses and the expectation of future losses forced many financial institutions to terminate their credit card operations and most others to severely restrict the amount of credit they made available to consumers.

The fact of the matter is that during that period of time, the cost of funds was so high and inflation was driving administrative costs up so rapidly that, had the free market been allowed to work, financial institutions probably would have had to charge rates well in excess of 20 percent just to break even or at most, to realize a modest return on their credit card portfolios.

Had that been the case, we would have witnessed a situation in which interest rates on credit cards and other forms of consumer credit would have peaked along with other rates in 1981 and then begun a decline of six or seven percentage points to their current levels, just as we have seen declines in other interest rates.

But that was not the case. Banks were not allowed to charge a market rate on credit card finance. If one examines the evidence submitted by the Consumer Federation of America, the most striking fact is that in the 80-81 period, credit card interest rates averaged around 17.5 percent: this at a time when the prime rate was nudging 20 percent. No one at that time questioned whether there was an adequately functioning market mechanism for the establishment of credit card interest rates.

But the banks that had to leave the business and the customers who were denied credit cards all understood that there was something wrong.

In the intervening years, banks sought and received legislative relief from these laws. (Most states still have usury laws, but their ceilings are much higher than they once were.)

This enabled financial institutions in most states to raise rates to a level where they were able to begin to break even or actually show a reasonable return on their credit card portfolios. The fact that banks were able to begin to recapture their costs by charging annual fees and raising their finance charges also meant that the average rate charged on credit cards began to rise toward a market clearing level, which is where they are today.

The second major fallacy is the argument that for some unexplained reason, the market is not working. If this were true, it would be an extraordinary development in an economy as diverse and dynamic as ours. Further, one would imagine that the proper course of action would be first to attempt to diagnose the cause of this market failure before prescribing a remedy.

Apart from war or natural disaster, the usual reasons for the breakdown in a market are runaway inflation, the existence of price controls, or the impact of a monopoly, oligopoly or cartel. We can dismiss the first two without much discussion. The inflation rate is down substantially and such usury laws as do exist are for the most part not a constraint on pricing in the current environment.

That leaves the structure of the industry to examine. The industry is clearly not a monopoly or an oligopoly. There are nearly 3,000 issuers of bank credit cards alone, not one of which has as much as 10 percent of the market, and another 13,000 participating financial institutions. Clearly, there is no excessive concentration of economic power.

The issuers for the most part are independent banks, some of whom issue cards only in a limited geographic area, and others who issue nationwide. Moreover, these financial institutions compete fiercely among themselves for deposits, loans and other financial services. It seems highly unlikely, therefore, that these same institutions would have either the inclination or the ability to form themselves into a cohesive cartel for the purpose of fixing prices on this one product alone and that this cartel could have survived with barely a defection for the last five years?

Cartels can survive only if they can adequately discipline their members and control entry of potential competitors. One need only examine the current disarry in OPEC to see the evidence of that. It has never been charged or demonstrated by the proponents of controls that there is any functioning mechanism for doing either within the credit card industry.

Even if there were a group of bankers, and even if that group constituted a majority, who were interested in keeping their prices (finance charges) artificially high and they were able to somehow institute such a price, the system would quickly break down. The reason, as OPEC has learned, is that some of the participants would quickly realize that they could greatly increase their profits and gain a significant market advantage simply by cheating.

Hence, to believe that such a conspiracy exists one must also believe that there is not a single banker in the nation who is interested in maximizing his profits. And we don't believe any of the proponents of this legislation are saying that banks aren't interested in profits.

So then what's wrong with the market? We respectfully submit there is nothing wrong with the market. It is functioning exactly as free markets everywhere function. Basic economic theory teaches us that in a normally functioning market, supply and demand will work to establish a price at a point where the marginal cost of providing goods or services exactly equals marginal revenue. In dynamic markets, those relationships are constantly shifting either because of shifts in demand, technological change or the entry of new competitors.

We are seeing all of that occur in the credit card market today. A number of large banks have begun reducing finance charges in the hope that they can move market share. Whether they are correct or not only time will tell. In addition, new competition has entered the marketplace in the form of the Sears Discover card, cards issued by several oil companies and numerous retail cards.

The question may then be asked; why hasn't it happened sooner? Part of the answer, we submit, has been given above. Interest rates on credit cards were artificially low in the early 1980's and only by maintaining those rates has the industry been able to return to profitability over the past three years. Now that the industry is once again profitable, some issuers have perceived an opportunity to either increase market share by trimming rates or enter the market anew. This is exactly the kind of behavior one would expect in a normally functioning market.

It is ironic, therefore, that we should be discussing the reimposition of price controls at a time when price cutting and the entry of new competition is just beginning to emerge.

The question must be asked; what impact would such controls have on this emerging competition? If these controls have the same impact that price controls have always had on this and other markets, there is no reason to assume that they will do anything to increase competition. Just the opposite; they will certainly decrease competition and the availability of credit.

The other part of the answer to the question, why hasn't it happened sooner, is that credit card interest rates are very different from Treasury bill and large CD rates. Not only are the latter unregulated, but they are established by a very different mechanism. T-bill, CD and similar rates are established in an open, auction market which reflects the collective impact of a great many forces, some of which are transitory in nature and others of which are more enduring. These forces are able to be transmitted and reflected very quickly through a very efficient market mechanism.

Furthermore, the rates cited by proponents of this legislation are not in fact the true cost of funds for bank card programs. The rates most often cited are current, short-term (90 day) rates. While it is true that this very short-term money is often included in the mix of funds that banks use to finance credit card receivables, it is not the only source. Banks use a variety of financing strategies to fund their receivables. These strategies vary widely from bank to bank, but in most cases include a blend of very short-term money and longer-term debt. This is not to say that the overall cost of funds for bank card programs has not declined over the last several years; it has. However, the decline has not been as large as it has been for the short-term rates most frequently cited by proponents of this legislation. While short-term rates such as the prime rate and Treasury bill rates have declined by as much as 10 points over the last four years, the average cost of funds for banks in the Visa system has dropped only four or five points.

But credit card rates also reflect a significant number of other factors, including salaries and wages, the cost of operating a worldwide telecommunications network for the authorization and clearing of transactions, fraud and credit losses and other operating expenses. While the cost of funds has come down, most of these other costs have continued to rise, a factor that proponents of controls rarely take into account.

What that adds up to is a market that is admittedly less efficient than auction markets. But the same statement could also be made for the market mechanism that controls the vast bulk of goods and services offered by American businesses to American consumers. There is always a time lag between the time the prices of raw materials decline (in this case the cost of funds) and the time that that decline is reflected in the prices of final products. For example, a one or two percent decline in the price of wheat is not immediately, and in fact may never be, reflected in the price of bread on grocers' shelves. Indeed, it is not uncommon for declines in raw materials to be more than offset by increases in prices of other factors of production.

This is an accepted fact of economic life and hence we hear no cry for the reimposition of price controls across a broad range of products simply because the market does not instantaneously reflect every nuance of every change in the cost of every factor that goes into making up final prices.

The third major fallacy is that the cost of funds to banks should be the sole criterion for determining the level of consumer interest rates. Certainly the cost of funds is an important element in determining final prices in the credit card industry; but it is not the only element, just as the cost of steel is not the only element that goes into the price of a car.

Even today, with cost of funds lower than it has been in years, that expense item constitutes barely 50 percent of the total expenses incurred by financial institutions in connection with the operation of their credit card programs, according to a 1984 analysis by the Federal Reserve System. What has not been taken into consideration are the many unique expenses incurred in connection with the operation and support of card systems, expenses which are not typically associated with other forms of credit. For example, each credit card system maintains a global telecommunications and data processing network. The Visa system alone, which responds to and records more than a million authorization messages and nearly five million clearing and settlment items each day, represent an investment of hundreds of millions of dollars. Comparable investments have been made by other credit card organizations. Participation in a credit card system also requires the maintenance by financial institutions of extensive telecommunications and data processing service facilities to support their operations or, in the alternative, procurement of those services from a third party.

Similarly, no consideration has been given to the significantly greater risks of fraud and credit loss assumed by financial institutions on the credit card. Unlike traditional installment credit which is generally secured and for which the risk of loss is easily estimated, the universal acceptability of the major credit card, together with inherent weaknesses of existing card authorization procedures, substantially increases the creditor's risk of credit and fraud losses. Although these risks will, in the future, be materially reduced through the development and installation of more point-of-sale terminals to authorize transactions and authenticate the identity of cardholders, such systems are still not sufficiently widespread to offer a significant level of protection. Implementation of such systems will, of course, necessitate significant, additional investment on the part of card program participants.

Another fallacy inherent in the arguments made by the proponents of controls is the idea that the credit card and traditional installment credit are somehow the same, with similar operating characteristics. Quite apart from the significantly higher operating costs detailed above, the credit card possesses many unique characteristics which make it a more desirable form of credit extension for the average consumer.

When a consumer receives a card, he gets more than just an open-ended, unsecured line of credit from his bank. He gets a payment device which he can use to purchase goods and services at approximately 2 million merchant outlets and obtain cash at approximately 61,000 bank branches and ATM machines in the U.S. alone. Worldwide, the card is accepted as payment for goods and services at more than 4.5 million merchant outlets in more than 160 countries.

In addition, in virtually all instances, cardholders have the option of paying account balances within a grace period, typically 25 - 30 days, without incurring finance charges. Within the Visa system, over 30 percent of all cardholders pay account balances in full each month, representing more than 50 percent of Visa card transactions, without any accrual of finance charges. The claims of proponents of controls that financial institutions are assessing excessive finance charges fail to consider the effect upon card issuers of the "free period" and the significant reduction in yield attributable to that failure.

The consumer, however, is well aware of the unique attributes of the card. Despite the availability of alternatives, each year since inception of the product the number of cardholders has increased significantly, as has transaction volume. Within the Visa systems, as of June 1985, cardholders totaled 88.1 million, up 15.9 percent from the previous year period. Payment service dollar volume increased 24 percent.

The consumer obviously finds the card a useful and valuable tool in the conduct of his everyday business and personal financial affairs. This being the case, it is fair to attempt to assess the impact on both the consumer and the industry should any of the proposed bills before this committee become law.

We estimate that had these proposed interest rate limitations been in effect during the last five years, fully 50 percent of the receivables held in member bank portfolios would have lost money. In other words, Visa member banks holding 50 percent of the credit card receivables in the system would have recorded losses for their programs. Since no business enterprise can tolerate losing money indefinitely, banks would have responded by cutting back on the number of credit cards available and limiting the amount of credit they were willing to extend.

And, judging by the value that consumers have placed on credit cards, it is difficult to imagine how anyone could argue that that would have been a pro-consumerist development.

We have cooperated with the American Bankers Association and MasterCard International in the preparation of a lengthy study by Lexecon Inc. which we believe represents a sound, reasoned analysis of the state of the industry and the seriously negative impact these legislative proposals will have on consumers.

STATEMENT OF THE
AMERICAN RETAIL FEDERATION
FOR THE RECORD
IN HEARINGS BEFORE THE
SUBCOMMITTEE ON CONSUMER AFFAIRS AND COINAGE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

ON

H.R. 1197 and H.R. 3408

TO LIMIT THE RATE OF INTEREST THAT MAY BE CHARGED
ON CREDIT CARD ACCOUNTS

October 29, 1985
Washington, D.C.

The American Retail Federation (ARF) is taking this opportunity to present for the record its views, comments, and suggestions regarding H.R. 1197 and H.R. 3408. ARF is grateful to the Subcommittee and its staff for this opportunity to make known its views on these important legislative proposals.

Membership in ARF consists of 27 national retail trade associations, 50 state retail associations, the Greater Washington Board of Trade, as well as corporate members. Through its members, ARF represents more than one million retail establishments.

The majority of retailers represented through the Federation offer or extend consumer credit, most of which is in the form of open end (i.e., revolving) credit. The vast majority of those open end credit plans involve the issuance and use of credit cards. For that reason, ARF is vitally interested in these two bills, and the impact that the passage of either bill would have (1) in general, on the availability of consumer credit to all consumers, including low income consumers; and (2) in particular, on the retail industry.

Both H.R. 1197 and H.R. 3408 would establish ceilings on the rate of finance charge that may be imposed on credit card accounts. Neither bill differentiates between credit cards issued by retailers and those issued by banks and travel and entertainment companies. Our comments and observations, however, are based upon the collective experience of retailers that issue credit cards for use in connection with open end credit plans. We cannot speak for banks and other nonretail credit card issuers.

The Retail Industry. The retail industry is based on free, open, and vigorous competition. Every day, retailers compete on the bases of price, quality and selection of merchandise, service, and an almost infinite array of other considerations that influence a consumer's decision to buy a particular product or service from a particular retailer. That competition includes credit terms made available to consumers who use credit. For example, right here in the Washington area, the terms of competing revolving credit plans vary widely. Some plans provide for relatively short-term pay outs, with the minimum payment set at 1/6th of the balance in the account. Other plans compete for customers in need of longer term financing, with minimum monthly payments ranging as low as 1/24th of the balance, and some plans have even lower minimum payments and longer terms for "big ticket" items.

Credit plans compete in other ways. Some sales promotions are coupled with special deferred payment terms. For example, sales of end-of-season merchandise in September may not be billed until the following February, with no finance charge assessed during the interim. In other special plans, no finance charge is assessed at all if the minimum monthly payment is timely received. These latter plans generally involve special promotions of silver, china, and/or crystal. Nonetheless, the credit terms are a competitive tool that has proven to be quite effective in the struggle for a share of the credit market.

That struggle, retailers believe is best left to the free market economy that over the years has produced a supply of goods and services that was adequate to meet consumers' demands and that did so at reasonable prices. In short, retailers exist in a competitive environment and believe firmly that the maintenance of such an environment is absolutely essential to the preservation of the high standard of living that the citizens of this Country enjoy.

The Impact on Consumers. One of the economic laws of a competitive marketplace is the law of supply and demand. Indeed, it is a law older than our constitution and one far more impervious to change than that venerable document. One of the corollaries of that immutable law is that when artificial restraints force prices down, supply is curtailed. Fewer suppliers are willing and/or able to continue offering the goods or services under the lowered price structure. Only the most efficient suppliers -- those that are able to operate on thin margins and are able to obtain high volume -- can remain in business. The reduction in availability on the consumer side of the equation is likewise not random across all income strata, but has its greatest impact on marginally creditworthy consumers. Those are the consumers who also typically have the lower incomes and greater need for reasonable amounts of consumer credit.

One way to circumvent such a result would be for retailers to raise retail prices sufficiently to compensate for the lost finance charge revenues. Such a practice, however, is a clear form of subsidy that inhibits price competition. Thus, when credit prices are restrained artificially, retailers face several possible alternatives: (1) they could discontinue offering in-house credit altogether, thereby reducing competition among suppliers in the credit marketplace; or (2) they could reduce the availability of credit, in which case those most in need of reasonable amounts of credit will be rejected; or (3) they could subsidize credit losses through an increase in retail prices, with the result that those customers who pay cash, whether by choice or as a result of reduced credit availability, will be paying part of the functional cost of credit that should be borne by credit customers. None of those alternatives is socially or economically desirable.

We fear that enactment of either H.R. 1197 or H.R. 3408 would have such a result.

The Concerns of Congress in the Past. Back in 1968, Congress realized that the whole issue (actually, the whole array of issues) involved in assuring an adequate supply of consumer credit at reasonable rates was, indeed, an enigma. As a result, Congress added Title IV to the Consumer Credit Protection Act (Pub. L. 90-321, May 29, 1968), Title I of which is the Truth in Lending Act, establishing the bipartisan National Commission on Consumer Finance and charging it with the duty to "study and appraise the functioning and structure of the consumer finance industry, as well as consumer credit transactions generally." (80 Stat. 499.)

After being funded for almost $2 million and after more than three years of intense study, that Commission filed a 294-page report with Congress in December 1972 (Consumer Credit in the United States, Report of the National Commission on Consumer Finance, Library of Congress card no. 72-600335.) The findings and conclusions of the Commission were lengthy and detailed, and all pointed to regulatory restraint rather than governmental involvement as the standard to be sought for the consumer credit industry. Among its conclusions were --

- "Imposition of rate ceilings on consumer credit transactions neither assures that most consumers will pay a fair price for the use of credit nor prevents overburdening them with excessive debt." (at p. 108.)

- "The Commission recommends that policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed." (at p. 149.)

- "Just as the level of rate ceilings may affect intra-institutional competition, so too can the structure of rate ceilings (as they apply to different credit sources) affect inter-institutional competition. When, for example, the ceiling applicable to a given type of credit for one class of lenders is substantially below that of another class of lenders, the former class will be forced to serve mainly low risk borrowers the latter, high-ceiling class will tend to serve relatively high risk borrowers. This artificial segmentation of the market obviously restricts inter-institutional rivalry." (at p. 137.)

This report was presented to Congress almost 13 years ago. In fact, three members of your full Committee served as members of the 9-member Commission. The conclusions and recommendations of the Commisssion are as valid and effacacious today as they were 13 years ago. Thus, ARF respectfully directs the attention of this Subcommittee to the Report of the National Commission on Consumer Finance -- a study for which this Country already has paid $1.95 million -- and urges that it heed the Commission's recommendations.

The Impact on Retailers. Finally, with respect to the impact that H.R. 1197 and H.R. 3408 would have on the retail industry, ARF strongly recommends that the Subcommittee not adopt the Federal Reserve discount rate on 90-day commercial paper as proposed in H.R. 1197. The Federal Reserve discount rate is the rate charged by Federal Reserve banks on extensions of short-term (typically, very short-term, often measured in days rather than weeks or months) credit to depository institutions secured by the pledge of receivables owed to the institutions from their borrowers. It certainly is not indicative of prevailing market rates. Moreover, the discount rate is an instrument of monetary policy, subject to control unilaterally by the Federal Reserve Board, and is used for such purposes as influencing the level of certain monetary aggregates. It is wholly inappropriate as an index for setting ceilings on credit card rates, and we urge this Subcommittee not to use it.

With respect to the 3-month treasury bill rate proposed as an index in H.R. 3408, ARF respectfully points out to this Subcommittee that, although the 3-month treasury bill rate is an indicator of the "market rate" of interest prevailing at the time, it is by no means indicative of the rate that retailers must pay to carry their receivables. Indeed, the market rate that must be paid by retailers varies widely with the size and credit rating of the retailer involved, the type of credit instrument used for the borrowings (e.g., short-term bank credit lines or long-term bonds), and the prevailing rates in the particular areas in which the retailers are borrowing the funds.

The bottom line is that the typical retailer does not fund its receivables with short-term borrowings at a cost measurable by either the 3-month treasury bill rate or the Federal Reserve discount rate; nor is the prime rate (either in New York or the area where the retailer is located) or any other short-term credit market rate a reliable indicator of the cost of money needed to carry retail receivables. The fact is that small retailers generally fund their receivables with a mixture of proprietary capital and intermediate-term bank borrowings, and large retailers typically obtain the funds necessary to carry their receivables by using a wide array of credit instruments, ranging from long term bonds, to revolving lines of bank credit, to invested capital. Few, if any, of these sources of funding are subject to rates that bear a significant and continuing relationship to the 3-month treasury bill rate or to any short-term rate.

As the National Commission on Consumer Finance noted, when the rate ceiling applicable to a given type of credit is substantially below that for other types of credit, the low-ceiling type will be available mainly to low risk borrowers, and the high-ceiling type will be offered to the relatively higher risk borrowers. Thus, if the Congress should decide to impose unrealistic ceilings on credit card accounts -- and we believe that the ceilings proposed in both H.R. 1197 and H.R. 3408 are, indeed, unrealistic -- the inevitable result will be to restrict those accounts to the most creditworthy customers and force retailers to "reinvent" closed end installment credit contracts for the less creditworthy customers, notwithstanding the fact that the use of closed end contracts has been largely abandoned in recent years because they are inconvenient to use. Artificially low rate ceilings will force creditors to resort to the use of this antiquated form of credit, one that had been left in desuetude with the advent of modern, electronic authorization systems which made the use of revolving credit practicable.

Consumers generally prefer revolving credit, because it is more convenient to use than is installment credit. It permits consumers to tailor purchases to available cash flow.

It must be remembered that the vast majority of consumers are not credit addicts or junkies; were that true, the credit industry could not function, for it could not survive in an environment in which large numbers of overextended consumers could not pay their debts. The vast, the overwhelming majority of consumers use credit sparingly and wisely and repay credit extensions according to schedule. Those consumers should not be forced to compete among themselves to determine the chosen few who are extremely creditworthy and who, therefore, get the right to use the form of credit that they all would prefer to use.

With respect to retailers themselves, it must be remembered that many thousands of retailers in this country today are small, locally owned operations. Some are still using mechanical billing equipment for preparing customers' monthly billing statements; others have small computers operating with software purchased off the shelf. Still others are using service bureaus with only limited programming capabilities. In short, many thousands of retailers in this country simply do not have the capability of using variable rates. Such an inability will force them, if either of these bills should become law, to adopt a fixed rate ceiling below the lowest foreseeable rate mandated by the variable rate formula. Given retailers' inability to adapt to variable rate ceilings, they would be forced to discontinue all finance charges when the ceiling went below their fixed rate. Obviously, this would place the small retailer at a competitive disadvantage which might not be overcome short of discontinuing credit operations.

Summary Over the years the retail industry has taken the position -- a position that has not changed -- that it makes no economic sense to fix the price of credit by artificial statutory restraints. The actual cost of noncredit services and the actual cost of merchandise to the retailer -- influenced, of course, by competitive market conditions -- determine the price at which the services and merchandise are offered for sale, either as a package or independently. For example, the price of a 21-inch color television set is based on the cost of that set to the retailer and the competitive market in which it is sold. It makes no economic sense, therefore, for artificial statutory restraints to fix the price that may be charged to finance the purchase of that television set, particularly in view of the fact that the cost of financing it typically is only a fraction of the cost of the set itself.

ARF urges that the cost of the credit service be subject to the same economic considerations that are involved in the pricing of the goods and other services offered for sale: the cost to the supplier and a competitive marketplace. Thus, we urge that the Subcommittee reject both H.R. 1197 and H.R. 3408.

ARF is grateful for the opportunity to present its views. If the Subcommittee or its staff should have any questions about the foregoing statement, ARF will be delighted to respond to your further inquiries.

Statement of the Chamber of Commerce of the United States

ON: H. R. 1197 AND H. R. 3408
LEGISLATION TO LIMIT CREDIT CARD
INTEREST RATES

TO: SUBCOMMITTEE ON CONSUMER AFFAIRS AND
COINAGE OF THE HOUSE COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS

BY: DR. RICHARD W. RAHN

DATE: NOVEMBER 12, 1985

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The Chamber of Commerce of the United States is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents almost 180,000 businesses plus several thousand organizations, such as local/state chambers of commerce and trade/professional associations.

More than 91 percent of the Chamber's members are small business firms with fewer than 100 employees, 57 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business—manufacturing, retailing, services, construction, wholesaling, and finance—numbers more than 12,000 members. Yet no one group constitutes as much as 29 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 54 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT
on
H. R. 1197 AND H. R. 3408
LEGISLATION TO LIMIT CREDIT CARD INTEREST RATES
before the
SUBCOMMITTEE ON CONSUMER AFFAIRS AND COINAGE
of the
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
for the
U. S. CHAMBER OF COMMERCE
by
Dr. Richard W. Rahn*
November 12, 1985

The Chamber of Commerce of the United States, on behalf of its more than 180,000 members, welcomes this opportunity to express its opposition to H. R. 1197 and H. R. 3408, legislation that would impose limits on credit card interest rates.

H. R. 1197 would limit the rate of interest on any credit card transaction to not more than five percentage points higher than the Federal Reserve discount rate. H. R. 3408 would limit the interest rate on credit card debt to six percentage points above the yield on three-month Treasury bills during the previous calendar quarter. The limits imposed in H. R. 3408 would not become effective if the Federal Reserve determined that prevailing loan rates reflect the cost of funds for creditors and competition for credit card accounts. Both bills would set floating ceilings on credit card rates that would supersede generally less restrictive state-imposed limits.

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*Vice President and Chief Economist, U.S. Chamber of Commerce

SUMMARY

Like all attempts to interfere with the operation of an efficiently working market, a federally mandated ceiling on credit card interest rates would have serious adverse effects on the U. S. economy if it would prevent interest rates from rising to market-clearing levels. From extensive experience with state-imposed limits and with the imposition of credit controls in 1980, which led to a sharp contraction in consumer spending, we know that regulatory measures can have unpredictable and undesirable consequences. Evidence suggests the possibility of reductions in the supply of credit in proportion to the degree of restraint imposed by the ceiling. The reduction in credit availability could take the form of credit flows away from consumers to other sectors of the economy in an attempt to avoid the ceiling. Empirical evidence also indicates that a below-market usury ceiling would lead to non-price credit rationing by lenders who would discriminate against low- and moderate-income borrowers and small businesses. Finally, imposition of a legal limit on interest rates runs contrary to the trend toward credit market deregulation embodied in the Depository Institutions Deregulation and Monetary Control Act of 1980.

Misguided Rationale for Federal Limits to Interest Rates

Proponents of federal limits on interest rates view them as a way to prevent lenders from exploiting unsuspecting borrowers. Although this is a legitimate goal, it is not clear that interest rate ceilings do anything to promote its achievement. In the first place, most business people do not need the "protection" afforded by interest rate ceilings because they have ample experience in negotiating credit terms on their own. Consumers and inexperienced borrowers, on the other hand, are adequately protected by truth-in-lending laws which require that the terms of credit be stated in clear, understandable language.

When interest rate ceilings discourage lending and encourage borrowing so that demand for credit is greater than the available supply at the legal ceiling rate, lenders will naturally favor the most credit-worthy customers. The result is that the poor and the small, risky businesses obtain little or no credit. Those who would have credit anyway are able to borrow at lower rates, unhampered by competition from those less advantageously situated who can compete effectively only when markets are free and unrestricted.

In fact, the most effective way to prevent exploitation in a market setting is to promote competition among sellers, especially price competition. By contrast, non-price competition, to which usury ceilings lead, contributes to inefficiency and unfairness. Thus, usury laws in general are counterproductive because they both restrict competition and encourage discrimination by lenders.

The Supply of Credit and Non-Price Credit Rationing

Two common responses of lenders to economically binding interest rate ceilings are a reduction in the supply of credit below the amount which would be offered in their absence and the denial of credit to customers who are judged to be poor credit risks at the maximum allowable interest rate. Evidence of these effects has been documented in numerous studies of the impact of state-imposed usury laws on consumer and mortgage credit. (For a comprehensive survey of the economic effects of state usury laws, see Harold C. Nathan, "Economic Analysis of Usury Laws," Journal of Bank Research [Winter 1980]). For example, the presence of usury ceilings on conventional mortgages within a state has been found to reduce the availability of mortgage credit and the number of housing starts within that state. For each percentage point below the estimated market-clearing rate, mortgage interest ceilings appear to reduce housing starts by 16 to 28 percent below their "free-market" levels. Business and agricultural investment in plant and equipment is probably affected in much the same way when state usury ceilings on commercial and agriculture credit are below market interest rates. Fortunately, the Federal government has permanently preempted state usury laws affecting residential first mortgage loans.

Regarding the effects of non-price rationing, eight independent investigations indicate that customers who are deemed to be poor credit risks are simply denied credit by lenders. These customers tend to be low- or moderate-income individuals or even young adults who have yet to establish credit records. These persons have no recourse but to go without credit or else obtain it from illegal sources. This non-price rationing could be prevalent among commercial lenders as well with obvious adverse consequences for small businesses which rely heavily on external funds.

Of course, lenders can also raise the non-interest costs of obtaining credit by increasing the following: annual fees on credit cards, processing charges levied on each purchase or cash advance, and penalties for late payments or for exceeding the authorized credit limit. Some card issuers also might apply the reduced finance charges from the date of purchase, where permitted, rather than after the grace period expires, and might seek to increase the merchant discount fees.

Inefficient Business Practices and Cost-Shifting

When interest rates rise, as they did subsequent to 1977, consumers, businessmen and farmers in states with restrictive interest ceilings find obtaining credit more difficult than do their counterparts in areas with less stringent ceilings. However, large businesses can often seek credit at alternate sources, something their smaller competitors may find difficult or impossible. This puts small firms at a comparative cost disadvantage and, thus, hinders their ability to compete. In short, restricting competition in credit markets can actually lead to less competition in product markets.

Even those firms which can obtain credit at market interest rates in other states may resort to inefficient business practices as a result of interest rate ceilings. The best examples are firms with "big ticket" items, such as construction and agricultural equipment. Because their customers in states with usury ceilings often have difficulty securing credit, these companies attempt to compensate by offering seller financing through captive credit companies. This expansion into the business of granting credit is contrary to the principle of specialization, which is the major source of economic progress. Moreover, the lending activities of these credit companies typically reduce the overall profitability of the company's operations within the restricted states.

The Macroeconomic Effects of Interest Rate Ceilings

Since an adequate supply of credit is vital to the health of an economy, it follows that artificial restrictions leading to diminished credit supplies or to misallocation of credit resources would have a deleterious effect on commerce. The only major study examining this question supports this distressing conclusion. The study estimated the macroeconomic costs to the state of Tennessee from 1974 to 1976 due to its comprehensive 10 percent interest rate limitation. (See Richard Gustley and Harry L. Johnson, Impact of the Tennessee Constitutional Usury Limit on the Tennessee Economy, Center for Business and Economic Research, College of Business Administration, The University of Tennessee, Knoxville, Tennessee [June 1977]). The study found that the state usury law resulted in an average loss of output of $150 million per year, an average loss of 7,000 jobs per year, retail sales losses of $80 million per year, and losses to financial intermediaries of $1.25 billion per year. Clearly, the economic cost to the national economy of such a law as a federally mandated ceiling on credit card interest rates would be staggering.

Conclusion

The available evidence confirms the predictions of economic theory regarding the adverse effects of interest rate ceilings. When such restrictions result in artificially low interest rates, they reduce the supply of credit and lead to inefficient, discriminatory non-price credit rationing. These distortions impose enormous costs on the economy and discriminate against low-income borrowers and small businesses, who are forced to go without credit.

National Retail Merchants Association
NRMA

TELEX—INT'L. 220 - 883 - TAUR
TWX—DOMESTIC 710 - 581 - 5380 TPNYK
ATTN: NRMA

1000 Connecticut Avenue, N.W
Washington, D.C. 20036
202/223-8250

STATEMENT OF

NATIONAL RETAIL MERCHANTS ASSOCIATION

ON

CREDIT CARD INTEREST RATES
H.R. 1197 AND H.R. 3408

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS AND COINAGE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

NOVEMBER 12, 1985

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President
JAMES R. WILLIAMS
NRMA
100 West 31st Street
New York, New York

The National Retail Merchants Association ("NRMA") welcomes the opportunity to present the views of retailing on H.R. 1197 and H.R. 3408, proposed legislation to establish limits on the rate of finance charge that may be charged on credit card accounts.

NRMA is the nation's largest trade association for the general merchandise retailing industry. Our members operate 45,000 leading department, chain, independent and specialty stores in all 50 states. NRMA members' annual sales exceed $150 billion, although the vast majority of NRMA's members are small, independent retailers whose annual sales are less than $1 million. Virtually all of NRMA's members extend credit by issuing their own credit cards or by accepting third party credit cards. For this reason these hearings are of great importance to the retail industry.

The Proposed Legislation

H.R. 1197 would amend the Truth-in-Lending Act to place an interest rate limit on credit card transactions of 5 percentage points above the Federal Reserve discount rate.[1] H.R. 3408 would place the limit on such rates at 6 percentage points over a similar index.[2] The latter bill would also require the Federal Reserve Board ("Board") to conduct a study of the relationship between finance charge[3] rates on credit cards for the period between January 1, 1979 and December 31, 1985 and the cost of funds to banks and other creditors and the degree to which rates reflected competition among creditors for new accounts during that period. If the Board's study indicates that rates are competitive with the cost of funds, the federal rate limitation would not take effect.

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[1] The discount rate on 90-day commercial paper in effect at the Federal Reserve Bank in the Federal Reserve district in which the card issuer is located.

Based on the indexes currently in effect, the ceiling on credit card finance charge rates under H.R. 1197 and H.R. 3408 would be 12.5% and 13.1%, respectively.

Introduction -- Retailing's Position

The proponents of these bills are attacking what they perceive to be excessive charges by banks, but the legislation is directed at the rates charged by all credit card issuers. Even though there may be significant differences between the way retailers and bank card issuers price the service of credit, and important distinctions between retailers and banks in terms of the cost of funds, the types and sources of revenues generated by credit cards, and the costs of operating the credit card department, these are not the principal bases for NRMA's opposition to these bills. Our views are based on fundamental principles of economics and the benefits consumers derive from a free market, and they are equally valid whether the credit card is issued by a retailer or by a bank. Thus, we would oppose these bills even if they were limited in application to bank card issuers, because they are based upon unsound economic policy.

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[2] The index used in H.R. 3408 is the the average annual percentage yield on 3-month obligations of U.S. Treasury obligations issued during the second month of the preceding calendar quarter.

[3] The term "finance charge" is used throughout this statement rather than "interest" -- the term used in both bills -- because that is the term mandated by the Truth-in-Lending Act to describe the cost of credit. "Interest" is the term associated with loan credit and is not properly used to describe credit extended by retailers and other non-lenders.

These bills should not be enacted, nor should they be used as the vehicle for developing revised legislation which might yield a more favorable rate structure for creditors. The notion of a federal ceiling on credit card rates is an unsound and inefficient regulatory measure and we will not legitimize it or temper our opposition to it in an effort to seek a more realistic rate ceiling. Our position is unequivocal -- the proposed bills, if enacted, would have a devastating impact upon credit card issuers, as well as major detrimental consequences for consumers as a whole. Set forth below are the principal reasons why this proposed legislation should not be enacted.

1. Prices (rates) should be established by the marketplace and not by government.

A rate ceiling imposed by law is tantamount to legislatively fixing the price of the service of credit. In a free market economy, price fixing is as inappropriate and inefficient when undertaken by government as it is unacceptable when it is done by private industry. It is also fundamentally inconsistent with other legislative developments in recent years on the federal level affecting the private sector in general and affecting credit granting in particular.

Federal laws have been enacted to deregulate the price of credit -- first in home mortgages and, subsequently, in all housing-related loans.[4] The proposed legislation would represent a major departure from this trend toward deregulation. It is opposite to the established wisdom that the private sector, not government, should establish the prices charged in a competitive marketplace in this country.

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[4] The Depository Institutions Deregulation and Monetary Control Act of 1980 preempted state ceilings on mortgage loans and business and agricultural credit. The states were given the option of overriding the mortgage preemption within three years from enactment and the federal preemption of state ceilings on business and agricultural loans expired on April 1, 1983. In 1981, this Act was amended to expand its coverage to all lenders extending housing-related credit.

Government should not attempt to control the profit margin earned by the private sector, as long as there are a wide variety of services offered by that industry and as long as consumers are assured that information is available on which to base a comparison of those different products. Both of these elements are prevalent in the credit card marketplace.

2. The current approach of assuring consumer awareness and reasonable access to the marketplace is the proper role of Congress in regulating credit card issuers.

Beginning with Senator Paul Douglas' introduction of the Truth-in-Lending Act in 1960, through its evolution into Title I of the Consumer Credit Protection Act in 1968, and continuing up to the present time, Congress has carefully considered the best way to protect consumers in the field of consumer credit.

In 1968 Congress decided to require that all creditors provide consumers with the information necessary to compare the different terms and rates offered in connection with a wide variety of credit products. Since that time Congress has done some "fine tuning", by enacting the Truth-in-Lending Simplification and Reform Act in 1981, and has enacted other consumer protection measures, but there is general consensus that the basic approach is as sound today as it was in 1969 when the Truth-in-Lending Act first took effect. Experience has demonstrated that Congress was right to adopt the approach of disclosure rather than imposition of substantive limitations upon creditors, such as rate setting. Consumers have the information to shop for credit and creditors have demonstrated that they will compete by varying the terms, benefits and features of their credit plans.

Congress has repeatedly resisted the temptation to regulate the price of credit. Indeed, the only federal legislative restriction on the manner in which credit card plans can be priced -- discounts for cash and imposition of surcharges -- has now been eliminated. Even these limited restrictions, however, were not directed to credit rates, but rather only to the issue of whether a discount and/or surcharge should be treated as a finance charge for purposes of disclosure. Congress has never legislated with regard to the amount of revenue a creditor should be permitted to generate from extending credit.[5] It should not do so now.

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[5] In early 1980 the Carter Administration imposed credit controls, with highly underdesirable results. Restrictions on the availability of credit cards were imposed, minimum payment schedules were increased, and numerous banks and retailers abandoned their credit card programs partially as a result of the credit control program.

3. Restrictive rate legislation results in reduced availability of credit, among other adverse consequences.

The Report of National Commission on Consumer Finance, *Consumer Credit in the United States* ("Report"), issued in 1972 after three years of study by a bipartisan panel of experts representing government, academia, industry and consumers, concluded that "the effect of restrictive rate ceilings is to limit the number of borrowers who qualify for legal credit and reduce the amount of credit supplied" (*Report*, p. 113). The *Report* concluded that another result is an increase in market concentration.

If either of these bills were enacted only the most creditworthy consumers would be granted access to credit cards because the service would have to be offered in an essentially risk-free environment. Many consumers would be excluded and forced to resort to other sources of credit, such as consumer finance company loans, the price of which would remain unregulated by this legislation. Thus, one result of enacting this legislation would be to effectively preclude the use of credit cards by many of the consumers whom the legislation purports to benefit.

Credit cards are still a privilege rather than a right. Banks and retailers need not offer them if they choose not to do so and they will not offer them to a broad range of consumers if forced to operate under restrictive terms.

4. Restrictive credit card rates could force creditors to shift to other credit products or different pricing of credit cards.

If Congress were to impose restrictive terms upon credit card issuers the industry could adjust, but consumers would not benefit. In addition to limiting the availability of credit, those banks that continue to offer credit cards could increase the annual fee and impose other charges, which are not restricted by the legislation, because they are not classified as finance charges. Banks could also replace the lost finance charge revenue by increasing the merchant discount -- the fee charged the merchant for purchasing the credit card receivable. In fact this has happened in Arkansas, where the merchant discount -- 5% to 6% -- is the highest in the nation.

Retailers could make adjustments as well. Those who do not offer proprietary credit cards, but accept bank cards, could be forced to pass the higher merchant discount on to all customers -- cash and credit card users -- in the form of higher cash prices for goods and services. This would have the highly undesirable effect of forcing cash customers to subsidize credit card users.

Merchants who issue their own credit cards in many states cannot charge an annual fee or impose other fees such as transaction fees or late charges. Retailers are also precluded under many state laws from eliminating the "free ride" that permits credit card users to avoid all costs of credit when they pay their bill in full each month. Thus, retailers could be forced to either abandon their own credit cards -- further reducing an increasingly concentrated credit card marketplace -- or extend credit only to the few who are the best credit risks. Neither result is in the best interests of consumers.

5. Consumers have choices -- they need not pay credit card rates that they consider too high.

Both the bank credit card and retail credit card continue to be an excellent buy for the American consumer. When used as a convenience, retail credit cards and most bank cards can be used free of charge. There is no finance charge for purchases when the bill is paid in full each month. Indeed, when purchases are timed immediately after the buyer's billing date, the consumer is assured of nearly two months of free credit (the month during which the purchase is made and the succeeding month during which the purchase is first billed). In fact a significant proportion of retailers' customers use the card as a convenience and pay their bill in full each month. If the consumer chooses to pay in installments, the finance charge is calculated on the outstanding balance each month and future finance charges can be avoided merely by paying the balance in full. These advantages are guaranteed under most states' credit laws.

Consumers have a wide variety of choices. In addition to using credit cards without paying finance charges, or paying in installments and controlling the amount of finance charge by varying the size of their monthly payment, consumers can also minimize credit card finance charges by using other types of credit. Personal loans, housing-related loans, check-accessed overdrafts, and other types of credit can be utilized, with a wide range of finance charge rates available. No one is "locked in" to a credit card rate which the consumer considers to be too high. Consumers choose to make purchases with their credit card, knowing the rate charged by the credit card issuer, because they want to do so.

6. The marketplace is working -- credit card issuers are competing on rates.

Although credit card issuers cannot adjust their rates with the rapidity of closed-end creditors, credit card rates are responsive to competitive pressures. NRMA has not undertaken a study of its members' rates or of bank card issuers' rates, but documentation of variations in rates is readily available. To name a few, The Bank of New York has been offering a rate of 17.94% on its regular Visa and Mastercard accounts and a rate of 15.96% in its preferred Mastercard.[6] Chevy Chase Savings and Loan in Maryland offers Visa and Mastercard customers a rate of 14%. Manufacturers Hanover, the nation's fourth largest bank, with nearly $1.4 billion outstanding in revolving credit products, recently lowered its rate from 19.8% to 17.8%. These are but a few of an increasing number of credit card issuers that are seeking to increase their market share by competing on the basis of rate. Consumers are free to examine the various features of each card issuer's program and, if they are creditworthy, they can and often do switch to a card offering a lower rate if the savings is deemed worth the effort.[7]

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6. The Bank of New York advertised a rate of 16.98% in The New York Times on October 24, 1985.

7. The savings could amount to $20 per year, or $1.66 each month, for an account with a $1000 balance assuming a rate reduction of 2% per annum.

7. Credit card rates should not be tied to the cost of funds.

The proposed legislation is precipitated by the recent decline in certain indexes, such as the prime rate, without a significant corresponding decline in most credit card issuers' finance charge rates.

This legislation is based upon a number of faulty premises, one of which is that it fails to recognize the difference between open-end credit card programs and closed-end credit. The latter is characterized by front-end costs (application processing, obtaining a credit report, issuing a payment book) which are often directly related to the short-term cost of funds. This type of credit does not involve periodic billing statements and numerous other operating costs which are found in open-end credit. The credit card program, on the other hand, has many costs which are not related to the costs of funds. Credit card plans involve postal expenses, data processing (multiple transactions, payment processing and monthly bill preparation, to name a few), account authorization costs, and many other costs which do not necessarily follow the changes in costs of funds.

It is also important to note that the cost of funds for most retailers is several points higher than the "prime rate" because most retailers rely on long term borrowing.

Even so, according to the Federal Reserve Board, during the period 1974 through 1984 financing costs averaged only 36 percent of total expenses for medium-sized bank credit card issuers and similar results have been found for retail creditors.[8]

8. Rate ceilings that are tied to a changing index are not workable for credit card programs.

Variable rate credit plans offered by creditors should not be confused with variable rate ceilings. The former are a valid option for certain closed-end creditors and these plans have become accepted practice for certain types of long-term financing, such as home mortgages. In fact, by the end of 1983 variable rate financing represented 44 percent of the loans used for home purchasing; 80 percent of mortgage lenders now offer variable rate financing.[9] Thus, in the case of closed-end loans, lenders are able to compensate for fluctuations in the cost of funds by extending variable rate credit.

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8. Although we have no current data on this issue, a study of retailers' credit card costs in New York in 1973 indicated that retailers' cost of funds amounted to 40 percent of total cost of credit.

9. Survey by Federal Home Loan Mortgage Corp., summarized in Wash. Financial Reports, Vol. 42, p. 189, Jan. 23, 1984.

A few states have chosen to respond to the need to change their rate structure by adopting variable rate ceilings instead of deregulating. The ceiling is tied to an external index, such as the Federal Reserve Board discount rate in the state's district. In such cases, the ceiling is usually set at a certain number of percentage points over the index selected.

As a matter of practice, retailers do not offer variable rate credit plans, for a variety of reasons. First, unlike mortgage creditors, in most states retailers operate under Retail Installment Sales Acts and the legality of variable rate plans is unclear. Even in those states where variable rate plans are permitted, the operational and disclosure problems can be insurmountable. Although certain retailers may find that variable rate revolving credit plans are operationally feasible, the point is that the creditor should be free to offer a variable rate plan if it chooses to do so. On the other hand, variable rate ceilings are a highly undesirable mechanism for controlling credit rates.

Variable rate ceilings present tremendous operational problems for retailers. For example, if the ceiling is set at 21% for a time and the retailer's rate is 21%, when the ceiling drops the retailer is faced with lowering its rate. Keep in mind that in all likelihood the retailer will not have a variable rate plan. That is, the retailer is offering a flat-rate plan -- it has not made the federal disclosures and extensive operational and computer program changes required of a variable rate creditor. Thus, a flat rate is required by the contract (Revolving Charge Agreement) with the retailer's customers and applicable state and federal law. Now, when the rate ceiling drops -- to say nothing of when it increases again -- the retailer is faced with several unacceptable choices. Unlike a closed-end creditor, who extends credit with each transaction at or below the rate that is in compliance with the variable rate ceiling statute at the time, the retailer extending revolving credit has to deal with the following problems:

a. The rate that is disclosed in the pre-printed account agreement (this disclosure is required by state and federal law) will be incorrect every time the rate ceiling changes, unless the retailer places its rates so far below the variable rate ceiling that its rates won't be affected when the rate ceiling goes down.

b. The rate pre-printed on each month's bill will also be wrong, for the same reason; many retailers do not have the capacity to computer-generate the rate disclosed on the monthly bill.

c. The retailer's rate cannot change to coincide with changes in the index because the retailer does not have the ability to allocate certain rates to certain balances (e.g., 21% to balances consisting of purchases made when that rate was legal; 18% to balances representing purchases made when that rate was permitted; 16% to other balances, etc.). Since this is not feasible, the creditor operating under a variable rate ceiling would be forced to apply the lower rate to all balances. This certainly would be an unfair result, because the customer and creditor both contemplated that at the time the particular purchase was made (e.g., the stove purchased when the rate was at 21%) it would be subject to the rate disclosed to the customer at that time. While the retailer might have the legal right, even under a variable rate ceiling statute, to continue to charge the rate applicable to the purchase, the retailer could not conceivably operate under a such a system. The disclosure problems (again, federal law requires extensive cost of credit disclosures on each monthly bill) and the computer program systems changes would make the simultaneous application of multiple rates to multiple balances an impossible task.

d. Rate increases, permissible if and when the variable rate ceiling increases, also cannot be readily implemented because of: (1) state and federal laws concerning notice of change in terms requirements (under federal law notice of the rate increase to all affected customers is required unless the creditor has adopted a variable rate plan), (2) breach of contract concerns (the consumer is arguably entitled to the old rate, at least until he or she uses the account after notice of the new rate), and (3) state law requirements which restrict the application of a new, higher rate to the balance that existed before the rate increase.

The above discussion merely illustrates some of the problems that can be encountered when the legislature chooses the wrong approach to regulating rates. The wrong approach is to establish a variable rate ceiling, because it is incompatible with retailers' revolving credit plans. Even in those few states which have adopted a variable rate ceiling (e.g., Arkansas and Texas) retail credit card issuers have been forced to treat those ceilings as fixed rate statutes, out of operational necessity, and as a consequence have pegged their rates at a point well below the index in effect in each state.

9. Rate regulation is the province of state legislatures, not Congress

The cost of credit has been regulated under state law since the early part of the century -- the inception of credit regulation in this country. The only exception came about when Congress acted in the area of rates because the ceilings under state law were too low, and, as noted earlier, that action was taken to remove ceilings in order to give consumers access to funds to purchase homes and, later, to refinance or borrow for other housing-related transactions.

A strong argument can be made in support of Congress acting to do the opposite of these proposed bills and remove all ceilings on credit.[10] A number of states have taken this action in recognition of the merits of allowing the marketplace, rather than government, to dictate the price of this service. In spite of this, we continue to support the right of states to enact provisions, such as rate regulation or deregulation, that they deem necessary for each state's citizens, while Congress prescribes the basic standards in areas such as truth-in-lending, fair credit billing, fair credit reporting, anti-discrimination, electronic funds transfer, and debt collection practices, which should be uniform for all citizens. Congress should not deviate from this regulatory approach. It should reject the enactment of a federal rate ceiling for credit cards or for any other type of credit.

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[10] The record established in April 1983 during hearings before the Senate Banking Committee on S.730 provides strong support for federal preemption of all state rate ceilings, including those applicable to credit card issuers.

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